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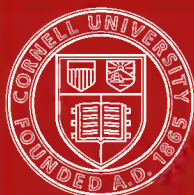
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FOREIGN EXCHANGE

THE FINANCING MECHANISM OF INTERNATIONAL COMMERCE

BY

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PREFACE

THE practice of most writers on Foreign Exchange is to treat their subject as a phase of the banking problem, emphasizing the bankers' methods of handling foreign bills of exchange, and giving but minor stress to the relations of the business man with the exchange markets. It is the opinion of the present writer that the needs of the business world and of the student are not adequately met by this common method of presenting the subject. The rapid expansion of the foreign trade of the United States, coupled with the abnormal condition of the exchange markets of the world, has increased, on the one hand, the importance of foreign bills in the transactions of our business men, and, on the other, the problems of national welfare and national policy which are the especial concern of the student. This volume is written with a view toward bringing into greater prominence these somewhat neglected aspects of the subject of Foreign Exchange. Without neglecting the banking mechanism through which the bills of exchange pass, the attempt is made to bring the discussion to bear upon the problems of the business man concerned with foreign trade, as well as upon the broader questions of national policy.

In stating and developing the basic principles of the subject, it has been necessary to assume a normal state of the exchange market, such as existed prior to the Great War. This method of treatment does not, however, place the book out of relation to present-day problems of the exchange markets. Wherever significant changes have taken place in the practice of the markets, allusion is made to these changes at appropriate points in the text as a means of emphasizing and qualifying the normal practices. That there is need for a thorough understanding of the principles which normally govern is daily disclosed by the devices which are put forward as remedies for existing abnormalities, and the attempts which are made to

explain the present situation by the logic of *post hoc ergo propter hoc*. After all, our present difficulties are produced by the outworking of the same forces which, in normal times, govern the markets unnoticed. We cannot understand the situation to-day, much less effect an intelligent correction of it, without a thorough comprehension of normal principles.

No claim is made that this book contains an original contribution to the subject; it attempts only to make our knowledge of Foreign Exchange more accessible and intelligible to the business man and the student. The writer has found it impracticable to refer at each point to the published work of others upon which he has drawn, for his indebtedness is difficult to measure. Especial mention should be made of Goschen's *The Theory of the Foreign Exchanges*, Spaulding's *Foreign Exchange and Foreign Bills*, Whitaker's *Foreign Exchange*, and of the publications of the New York banks and the Federal Reserve Board. To Mr. Karl Llewellyn, formerly of the faculty of the Yale Law School and now of the legal department of the National City Bank, I am particularly indebted for contributions to the legal phases of the subject and for helpful criticism of a large part of the manuscript.

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INTRODUCTION

THERE appears to be a fairly common impression that there is something peculiarly mysterious or recondite about the subject of foreign exchange. Professor Furniss's lucid and well-proportioned account should do much to correct that impression. The truth is that the operation of the foreign exchanges is in many respects simpler and less obscure than that of other parts of our monetary mechanism. That the subject has this undeserved reputation for obscurity must be attributed, I suppose, to the manner in which the books have dealt with it.

Books on foreign exchange fall for the most part into two classes. First, there are the books that are weighted down with purely technical details respecting such matters as monetary standards, commercial laws, stamp taxes, the arithmetic of exchange rates, and the like — excellent desk books, doubtless (if only they could be kept up to date), for dealers in exchange. Second, there are the more philosophical discussions, dealing with the general principles of foreign exchange. Too many of the books of this second type make the subject unduly obscure by making it unduly abstract and unreal or by entangling it with the intricate problems of the general theory of international trade.

Professor Furniss has chosen a middle course. On the one hand he is careful to avoid petty technical detail. On the other hand he is equally careful to keep close to concrete realities. For these reasons, I believe, his book will commend itself to two different classes of students. Those who, in schools of commerce or elsewhere, are preparing themselves for business careers will find in it an orderly account of the principal operations of the foreign exchange market. He leaves to one side such minor matters of detail as can be more profitably acquired through actual experience in the work of the foreign exchange department of a bank. Those whose inter-

ests are in economic science rather than in affairs will find that the best approach to the study of foreign exchange — as to the study of other monetary problems — is through the analysis of the actual mechanism of the market. In these matters Professor Furniss, writing with first-hand knowledge of his subject, is a safe guide.

I suspect that the largest use of the book will be as a text in colleges and schools of commerce. But other readers will be attracted to it by the present importance of the subject with which it deals. During the last few years disordered exchanges have stood in the way of the full restoration of that international economic coöperation upon which, under modern conditions, the economic welfare of the world depends. In foreign exchange, as elsewhere, our attention is rarely drawn to certain of the most fundamental and elementary features of our monetary mechanism until, for some reason, that mechanism fails to operate smoothly. In this respect, of course, the present volume has an advantage over such descriptive accounts of the foreign exchange market as were written before the war. While avoiding disproportionate emphasis upon what we may hope is only a temporary phase, it affords an excellent introduction to the study of the factors which determine the price of exchange upon (or in) a country with an inconvertible paper currency. This feature, quite apart from its other qualities, will commend it to many readers.

ALLEN A. YOUNG

FOREIGN EXCHANGE



CHAPTER I

NATURE AND USE OF BILLS OF EXCHANGE

1. Introductory. When viewed as a whole, international trade is barter; the people of one nation obtain a supply of the goods and services of other peoples by offering in exchange the peculiar products of their own land and labor. The ability of Americans to command for their own use a share in the production of foreign peoples is conditioned upon the desire of foreigners to obtain a portion of our national product. In other words, our power to import is limited by our ability to export. Conversely, when we consider all nations outside our own boundaries as a unit, it is apparent that the ability of foreign peoples to buy our goods is conditioned upon our willingness to accept their goods in exchange, since they have no other means with which to make payment. Hence, our power to export is limited by our willingness to import. Nations, like individuals, may, it is true, fall into debt to each other on account of business transactions which remain uncompleted; but in the long run, men, whether in groups or as individuals, will refuse to surrender their wealth to one another except in exchange for other wealth.

If international trade were carried on by national groups instead of by individual business men, the use of the exchange market, and of the many different forms of credit instruments with which our modern money economy complicates the basic forces underlying the commerce of nations, would to a great extent disappear; however, in spite of these complexities, the principles of barter are still the governing

principles of international trade. This fact must be firmly grasped at the outset of any study of foreign exchange; for, as we shall see in due course, it is the barter of goods for goods in international trade which controls the operations of the exchange markets of the world.

Since the world's trade is not carried on by national groups, but by individual business men, each in pursuit of private profit, the problem of effecting payment in international commercial transactions is one of great importance. The American manufacturer or merchant who has found a market for his goods outside our boundaries cannot exploit this opportunity to his own advantage unless some agency is available through which he can obtain from his foreign customer the amount due him. It is no aid to the conduct of his business to be told that the nation of which he is a member must in due course receive from foreign peoples payment in goods for all commodities exported. The problem of the individual trader is immediate and practical; he must receive in dollars and cents, and without too great delay, the sale price of his goods, otherwise he cannot meet the current expenses of his business and must withdraw from foreign trade. At the same time, the peculiar complexities of foreign trade deny him recourse to many of the means by which he is accustomed to make collection from debtors in the domestic market. The distance which separates the two parties; the difference in language, business customs and legal institutions; the fact that the foreign buyer's money has no currency in the seller's market and that his checks and other credit instruments will not be honored by the seller's banker, increase the seller's reliance upon some agent capable of bridging the distance between the two markets and resolving the sum of money paid out by the foreign buyer in a distant city and a foreign coinage into a sum available in the seller's city and in the coinage of his nation.

This need of the exporter can be most simply met by the offer of a third party to assume the exporter's right against his foreign customer and to pay the exporter, either immediately or at some definite future date, the sum of money owing him.

If this third party is a neighbor of the exporter operating under the same laws and customs, the problem of financing foreign sales loses much of its complexity. In actual practice, payment for the greater part of the world's international trade is effected in precisely this manner: by a transference to a third party of the seller's claim against the buyer in consideration of a payment of money by the third party to the seller. The third party in question is the foreign exchange banker; the instrument which gives effect to the transfer of rights is a bill of exchange.

2. **Definitions.** As defined by the Negotiable Instruments Law a bill of exchange is "*an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to order or to bearer.*" There are three parties to this transfer of funds: A orders B in writing to pay a stated amount of money to C (or his order) either on demand or at a definite future time. These parties are given distinctive names: A, who writes the order, is known as the *drawer*; B, to whom the order is addressed, as the *drawee*; C, the recipient of the money or beneficiary of the order, the *payee*. In the market, bills of exchange are differentiated to a certain extent according to the character of the drawers; thus the term, *banker's bill*, is used to describe a bill of exchange whose drawer is a banker, and the term, *commercial bill*, one whose drawer is a merchant or business man. The practical effect of this classification upon the treatment of the different bills of exchange by the exchange market will presently appear.

Again, bills of exchange are classified according to the method used for determining the date upon which payment is due from the drawee. From the definition which has been given, it will be seen that the date of payment may be either "on demand" or "at a fixed or determinable future date." A bill of exchange payable on demand is called a *demand* or *sight bill*, or, frequently, a *check*, for upon examination it will appear that the credit instrument known as a check, so commonly used in domestic transactions, answers all the re-

quirements of the definition for a demand bill of exchange. All bills payable at a future date are grouped together as *time* or *long bills*. But the time bill may be so worded as to specify either of two different methods of determining the future date upon which payment is due. If A's instructions to B, borne by the face of the order, read, "Pay to the order of C one hundred dollars thirty days *after date*," the order becomes payable thirty days after writing regardless of any loss of time involved in presenting it to B; it may, therefore, result in giving B less than thirty days in which to prepare for payment after presentment. On the other hand, if A's instructions read, "Pay to the order of C one hundred dollars thirty days *after sight*," the bill does not commence its life until it has been presented to B, who is accordingly allowed thirty days' time in which to prepare for payment. In foreign trade the majority of time bills of exchange are drawn payable after sight, though the practice of making them payable after date is not unknown and is growing in favor for reasons which will be discussed.

In no case may a bill of exchange be drawn payable at a date which depends upon the occurrence of some non-predictable future event, for such terms would violate the prescription of the law that the date of payment must be either fixed or determinable. It frequently happens that the basing of the date of payment of a bill of exchange upon the arrival of a ship or the delivery of a consignment of goods would be a convenience to both buyer and seller; but these expedients cannot be adopted, for the courts will hold that an order so drawn is not a true bill of exchange and the bankers will refuse to negotiate it because of this weakness. However, when the convenience of permitting the drawee to calculate the date of payment on the basis of such an event is especially great, informal custom often sanctions a departure from the strict terms of the order. Assuming, for example, that the drawee is a South American importer of merchandise from the United States, and the drawer, the exporter to whom is due the sale price of the merchandise, the custom of the drawee's market may permit him to postpone payment of a

sight draft or the calculation of the date of payment of a time draft until the goods have arrived and have been examined. In fact, this custom is so firmly rooted in certain South American countries that the refusal of the drawee to pay a sight draft until after the arrival of the goods leaves the drawer no recourse but to acquiesce, despite his apparent legal right to enforce payment upon presentation. Similar customs obtain in other countries, in Holland, for example, where the payment of a sight draft is ordinarily postponed until three days' notice has been given the drawee. Because of such local customs, it is impossible to say that demand or sight drafts are always paid on presentation. In the case of time drafts, too, the date of actual payment is somewhat affected by local laws regarding "days of grace" which extend the date of payment after maturity from one to ten days according to the practices of the particular country or state in which the drawee lives.

Since the bill of exchange is an order to the drawee to pay out a sum of money, the drawing of the bill may be taken as presumptive evidence that the drawer has a legal right to demand this sum from the drawee. But it must not be assumed that possession of the bill of exchange bestows upon the *payee* a right of action against the drawee, even when the drawer is a *bona fide* creditor and has acted well within his powers in addressing the order to the drawee. The possession by C of A's order instructing B to pay a sum of money gives C no power to enforce the order by legal action in case B chooses to disregard the instructions. If B's refusal to honor the bill is a violation of some agreement he has made with the drawer, any action brought against him must be brought by the drawer and must be based on his violation of the contract in pursuance of which the bill was drawn.

To transfer this right of action against the drawee from the drawer to the payee of the bill of exchange, the order must be presented to the drawee and receive his acknowledgment. If the bill is drawn payable upon demand, the drawee's acknowledgment of the order will, of course, consist simply of his payment of the amount of money stated on

its face. If it is a time draft, however, the acknowledgment must be given in such form as to bestow upon the holder of the bill a right of action against the drawee in case payment is refused at maturity, and this the drawee usually does by writing the word "accepted," together with his signature and the date, across the face of the order. After this act, whose effect is to transmute the order into the drawee's promise to pay at a definite future date, the bill of exchange will be spoken of as an *acceptance* by the business world and may change hands before maturity upon terms which reflect the estimate placed by investors in the acceptor's willingness and ability to discharge his debts; for now its lawful possession will give the holder legal right of action against the drawee (acceptor) in case of dishonor at maturity. There are, however, certain significant differences between the acceptance and the ordinary promissory note, but discussion of these differences may be postponed until the procedure in event of the drawee's dishonor of the order has been explained.

Dishonor of a sight bill of exchange consists simply in the drawee's refusal to pay the sum of money stated in the order; in the case of a time bill, two opportunities to dishonor the order are given the drawee: he may refuse to give the order his acceptance, or, having made the acceptance, he may refuse to redeem the bill in money at maturity. The last-named form of dishonor is obviously different in nature from the other two, for a refusal to redeem an accepted bill is a repudiation of the drawee's own written obligation, while refusal either to accept a time bill or to pay a sight bill is merely a disregard of the drawer's order. In most cases, the act of dishonor will be made the cause of legal measures against the drawee either by the drawer or by his representative, and it is the custom to improve the drawer's legal position in preparation for the action he will presently bring against the drawee by obtaining a formal legal record of the fact that dishonor has occurred. This is called *protest*.

The formalities connected with the protest vary in different countries in conformity with variation in the legal institutions,

but the purpose is in all cases much the same, and the method reflects to a certain degree this uniformity of purpose. The holder of the bill who has been unable to obtain the drawee's acceptance or payment upon presentation appears before a notary public, or similar public officer, and makes formal protest against the act of dishonor. The fact of the drawee's refusal being established, the protestor receives a certificate bearing the notary's signature which becomes a legal record that presentment has been made and dishonor has occurred. It may be well to repeat that this action is taken for the benefit of the drawer, to whom, accordingly, all expenses connected with the protest will be charged. These expenses may be so large, or the virtue of the protest in improving the drawer's position in the courts may be so slight, that the action is not deemed worth while; this is a matter for the drawer of the bill to decide, either at the time the bill is originally transferred to the payee, or when, later, he is informed that dishonor has occurred. In European countries and in the United States, protest is almost invariably made unless the amount of the dishonored bill is very small. In some other countries, and especially in certain South American republics, the value of the protest is scarcely worth its cost.

A bill of exchange before acceptance is, to repeat, merely an order of the drawer; it is not a promise to pay a sum of money. If the drawer succeeds in transferring it to a third party — banker, or dealer in foreign exchange — in exchange for an immediate payment, it is because this third party has confidence in the drawer's willingness and ability to make restitution in case the order is not obeyed. The bill of exchange, in other words, should be viewed as a credit instrument of the drawer, resting upon his signature, and obtaining its marketability from his legal obligation to make good money invested in it. It is, indeed, a misuse of words to speak of a drawer's *selling* a bill of exchange to a banker; he does not, in fact, sell, but *borrow*s, using the bill as security for the loan and assuming a liability similar to that borne by any borrower, except that his liability is contingent upon dishonor by the

drawee. This liability of the drawer terminates only with the payment of the order by the drawee; in the case of a time bill, it does not end, as might be supposed, when the drawee's acceptance has been obtained. Up to the point of acceptance, the time bill of exchange rests solely upon the credit of the drawer; after acceptance, although it becomes the direct obligation of the drawee, the drawer's name remains upon the bill and his liability is not removed, though it now becomes contingent upon the drawee's failure to redeem his acceptance at maturity.

To make this clear, let us contrast the credit standing of an acceptance with that of a promissory note, by assuming that the acceptor of a bill of exchange has had occasion in the course of his business to issue a promissory note of a like amount. From his point of view there is no difference in the liability created by these two credit instruments; both are his direct obligations, and the holder of either can enforce payment by legal action in case of default. But from the point of view of the creditor a significant difference obtains. If default should occur, he, as holder of a promissory note, would have recourse to no other party than the issuer of the note, unless there happened to be endorsers. But, as holder of an acceptance, he may bring action, first against the acceptor, then against the endorsers if there are any, and finally against the drawer. Thus the acceptance is founded upon the credit of at least two parties, and because of this double security it commands a high investment standing which explains in large part the wide use of time bills in financing commercial transactions. It is our present purpose to emphasize the fact that the drawer's liability does not end with acceptance, but extends, as a contingent liability, beyond that point to the ultimate redemption of the bill of exchange. Many business men, accustomed to the use of bills of exchange, do not fully realize the extent of their liabilities as drawers.

3. Commercial use of bills of exchange. The bill of exchange has its origin in a creditor-debtor relationship which places one individual under the necessity of paying out

money at the order of another. This relationship may be produced in an indefinite number of ways, most common among which is the sale of goods, services, or property rights without advance payment of the purchase price. Every such sale "on time" affords the opportunity, both parties agreeing, to effect payment by means of a bill of exchange which transfers the seller's claim upon the buyer to a third person who is willing either to pay for it immediately, or to undertake the collection of the amount due and its eventual transference to the seller. Many bills of exchange, however, arise not out of transactions between merchants, but from those between bankers, who often create a creditor-debtor relationship for the express purpose of enabling one banker to draw bills upon another and sell them for a profit. In this preliminary discussion, it will be our purpose to give attention to those uses of bills which originate in commercial transactions between business men in different markets, for upon this economic foundation rests the entire business of foreign exchange in all its many and varied aspects.

Since there is no essential difference of principle to distinguish the foreign bill of exchange from the domestic, an example of the commercial use of the latter and more familiar form will serve to illustrate the nature of both. Suppose, then, that a wholesaler in New York sells \$5000 worth of linoleum to a jobber in Minneapolis, the terms of sale providing that the seller shall draw at sixty days' sight against the buyer as soon as the shipment has been made. The goods are shipped and the wholesaler has in hand the railroad's bill of lading whose holder alone can demand delivery of the goods in Minneapolis. He now goes to his banker in New York and arranges to transfer to him his right to receive payment from the jobber, the bill of lading to pass to the banker as his security in the transaction. The bill of exchange which gives effect to this transfer of credit will appear as shown in Form 1, page 10.

The banker, relying upon the credit of the shipper and upon the additional security of the bill of lading which represents the goods shipped, may agree to advance the full present

Accepted October 4, 1921

Payable at Minneapolis Bank

..... Minneapolis, Minnesota

(Signed) Minneapolis Jobber

FORM 1. DOMESTIC BILL OF EXCHANGE

\$5000.⁰⁰/₁₀₀

New York City October 1, 1921

Sixty days after sight Pay to the order

of Ourselves

..... Five thousand and ^{no}/₁₀₀ Dollars

As per invoice of October 1, 1921.

Value received and charge the same to the account of

..... New York Wholesaler.

To Minneapolis Jobber
.....

Minneapolis, Minnesota
.....

value of the bill at once, in which case he will discount the face of the draft for sixty days at the ruling rate of interest, subtract his commission and any other charges, and place the proceeds — say, \$4950 — to the wholesaler's credit. On the other hand, he may agree to take the bill for collection only, making no payment until it is redeemed at maturity; or, he may combine these two policies by advancing a part of the face value of the bill, holding the remainder in reserve as additional security until redemption is made by the jobber. Though all three methods of handling the bill of exchange are to be found in actual practice, we may assume for the sake of simplicity that the drawer in the present instance receives an advance of the full present value. In this case, he, the wholesaler, is out of the transaction; he has made his sale, shipped his goods, received his money, and can go about his business without concern as to the future history of the bill of exchange, except that he will bear a contingent liability to refund the money to the banker in case the jobber refuses to accept or to pay the draft. At this point one of the chief functions of the commercial bill of exchange appears: it makes possible the sale of goods on credit and yet may provide immediate payment for the seller.

Let us follow the transaction further. The draft, which has been drawn payable to the New York banker, is endorsed by him and sent forward with the bill of lading to a bank in Minneapolis. It is presented to the jobber, who writes "accepted" and signs his name across the face, thereby assuming the obligation of redeeming it at maturity. If the jobber's promise to pay is acceptable to the Minneapolis bank without further security, he may then take the bill of lading and obtain his goods from the railroad company. For him, too, the transaction is temporarily closed: he has the goods in his possession and may proceed to make his sales and deliveries to the retailers. For sixty days the draft must be held by the Minneapolis banker, or by some one else who has bought it as an investment; during this time it will be growing in value as interest accrues, until at maturity it becomes worth its face — \$5000. Before his acceptance falls due, the jobber

will have deposited with his bank funds sufficient to meet his obligation and out of these funds he will pay the \$5000 he owes. Here appears another function of the commercial bill of exchange: payments due between merchants far removed from each other are made with ease, both creditor and debtor dealing only with a neighboring banker in his own market. There then remains the relationship created between the two banks concerned with the bill of exchange. Money paid out by a bank in New York has been returned with increase to a bank in Minneapolis, held there to the credit of the New York bank. We shall not, at present, inquire into the methods employed to dispose of this credit, reserving this problem for discussion in another place.

If in the preceding illustration the goods had been sold in a foreign market, the bill of exchange by which payment was effected would have differed in no essential respect. The foreign bill of exchange, in a transaction similar to the foregoing, would, however, be drawn in the money of the debtor's country and sold by the creditor for its equivalent in the money of his own country. This involves the translation of one monetary system into another and requires a determination of the relative values of the standard coins of the two systems. For example, a cotton dealer in New York sells a number of bales of cotton to a Lancaster spinner, who has agreed to accept a sixty-day sight draft for the amount of the shipment. The importer will, of course, pay in the money of his own country and the exporter in drawing upon his foreign customer must transfer to the buyer of the bill the right to receive the money which will actually be paid — say two thousand pounds sterling. When the cotton is aboard the steamer, consigned to the buyer and insured against loss in transit, the seller takes his bill of lading and insurance policy to his banker in New York and transfers to him the right to receive the two thousand pounds from the Lancaster spinner sixty days after the bill has been accepted. The draft by which this transfer of credit is made will appear as in Form 2, page 13.

The necessity of translating two thousand pounds sterling

FORM 2. FOREIGN BILL OF EXCHANGE

£2000.....

New York City October 1, 1921.

.....sixty.....days after.....sight.....of this

FIRST OF EXCHANGE (Second of the same tenor and date unpaid) pay to the

order of.....Ourselves.....

.....two thousand pounds sterling.....

For value received and charge to account of

To .. English Importer.....American Exporter.....

Manchester, England.....New York City.....

into dollars and cents arises during the negotiations between the exporter and his banker. When this has been done, if the face value of the bill is to be advanced to the drawer, the discount and commission charges will be subtracted, and the proceeds paid out by the banker. For the exporter, aside from his risk of being required to make restitution in case of default by his foreign customer, the transaction is now completed. The handling of the bill will proceed upon much the same lines as in the case of a domestic draft. It will be endorsed and sent with the bill of lading and insurance certificate to a correspondent bank in England, with which the New York banker has formed an agreement covering the details of such transactions. Upon its arrival, it will be presented to the drawee for acceptance, after which it may either be sold in the discount market of London, or held as an investment until maturity by the correspondent bank under instructions from the American bank. In either case it will sooner or later produce an inflow of funds into the bank in England to be credited to the account of the New York bank which advanced the money in the purchase of the bill.

If, to digress for a moment, the New York banker had taken the cotton exporter's bill for collection, the drawer would have been required to wait until the bill had matured and had been redeemed by the English importer before its value was turned over to him. But this variation of detail would not greatly change the future history of the bill; it would be sent to England for acceptance and eventually redeemed by the importer, at which time the funds accruing from the collection, paid to a bank in England, would be delivered by the New York bank to the seller of the cotton. After the transaction had been cleared up for both merchants, regardless of whether the draft was originally bought or taken for collection, and regardless, also, of whether it was sold in the London discount market or held by the correspondent as an investment, there would remain an uncanceled creditor-debtor relationship between the New York banker from whom the shipper had received his money and the English banker to whom the importer had paid his draft. This simple trans-

action is illustrative of the method by which payment is received for most of our immense exports and, indeed, for the largest part of the exports of all countries. The time draft, drawn for sixty or ninety days' sight by the exporter, is the typical financing instrument in international trade.

4. **Banking relations created by foreign bills of exchange.** In the preceding illustration the transaction in foreign exchange was left at the point where a payment was due from the London banker who received the importer's payment to the New York banker who purchased the exporter's bill of exchange. It is apparent that by advancing money against the bills of exporters and sending these bills forward to their respective countries, the banks of America are virtually transferring a portion of their funds to foreign cities, for each purchase of a bill in this country diminishes the cash resources of the purchasing banker, while each collection abroad returns the purchase price in a foreign coinage to a foreign correspondent. Obviously so one-sided a transaction could not long continue without driving American banks engaged in foreign exchange out of business, for no banker can continue operations when his funds are held in foreign money centers.

But international trade is not a one-sided matter; goods are imported as well as exported, and the business men of all countries have payments to make to foreign customers as well as payments to receive from them. If we assume for the moment that it is the universal practice in foreign trade for the exporter to draw upon the importer, as did the cotton merchant in our hypothetical example, it will become clear that the import trade of the United States must set up a current of bills which gives English and other foreign banks credit with banks in this country just as our export trade gives American banks credits abroad. For example, an English merchant who exports china-ware worth two thousand pounds sterling to an American customer would draw for the equivalent of this amount in dollars and cents upon the buyer and dispose of his bill to his bank in England. The draft would be forwarded to an American correspondent, presented to the drawee, and eventually redeemed, at which time the proceeds

would be placed to the credit of the English banker who first acquired the draft. If the same pair of banks should happen to handle both the cotton and the china bills, the two credits would offset each other and the accounts of the bankers as well as those of the merchants would be cleared. The identity of the banks concerned in the two transactions is, of course, purely accidental. But view the New York and London markets as a whole, disregarding the individual bankers who compose the markets, and it must be clear that the two transactions we are considering will create equal and offsetting credits in the two markets. Expand the illustration to include the whole of our trade with Great Britain and it will appear that a multitude of transactions arising out of our import trade are continually placing the New York market in the debt of London, while similar transactions arising from our export trade are continually reversing this creditor-debtor relationship. Cancellations of offsetting debits and credits are, therefore, constantly in process between the two markets leaving only a net balance — small in comparison with the total trade — to be paid by remittance from one city to the other.

The process of clearing the accounts of the bankers by cancelling debits against credits appears feasible so long as the foreign trade of the nation is financed by drafts of exporters against importers. We have now to extend our inquiry to include other ways of effecting payment by means of bills of exchange and to see that, whatever the method used, so long as a bill of exchange is employed in the transaction, the effect upon the relationship of the banks will be the same: the export trade of the nation will create for its banks credits in foreign markets; the import trade, countervailing debits which may be offset against these credits. For our present purpose it is not necessary to examine in detail the different kinds of bills of exchange which arise from international commerce or the different ways in which these bills are customarily handled by the bankers; this we shall do in later chapters. Disregarding differences of detail, payment in international trade is effected by means of bills of exchange in

either of the following ways: (a) by the exporter's order, drawn upon the importer or his banker for the amount due; (b) by remittance from the importer to the exporter of a bill of exchange equal in value to the amount of the debt. The former of these methods has been covered in the preceding discussion; we shall now see that the use of the second method creates precisely the same creditor-debtor relationships between the banks, as does the use of the first.

Suppose that the merchant who imports china-ware from England has agreed to terms of sale which require a remittance upon arrival of the goods. How will this remittance be made? The importer has a choice of two alternatives: he may send the purchase price in gold, or in the form of a paper instrument acceptable to the exporter. Of these alternatives, the former will undoubtedly be avoided if possible because of the trouble and expense involved in shipping the gold; the importer will avail himself of the latter if an acceptable paper instrument can be obtained. The English exporter will require only that the instrument be of such form that he can cash it at his bank, and this requirement will be answered by a banker's demand bill of exchange, or check, drawn by a New York bank against a bank in London. Accordingly, the American importer goes to his banker and by a payment in dollars and cents buys a demand draft for two thousand pounds sterling made payable to himself (the importer). Endorsed and sent to the English exporter, this draft may be deposited in any bank in England, giving the depositor an almost immediate credit of two thousand pounds; for the process of presenting the draft for encashment to the drawee-bank in London will consume but a few hours and the exporter's banker will transmit the proceeds to his account. This form of remittance is entirely acceptable to both merchants, since it allows each to make or receive his payment in the money of his own country and to conduct his transactions with his own banker.

But this service to the merchants is rendered by the banks in the two countries only because they are willing to assume for themselves the creditor-debtor relationship created by

the sale of the china; for after both importer and exporter are freed from the transaction, the New York bank which received the importer's money will remain in the debt of the London bank which honored the draft. Clearly, therefore, the use of bills of exchange in making payment for goods imported into this country, whether the bills are drawn by the foreign exporters or bought for remittance by the American importers, will have the effect of placing American banks in the debt of banks in foreign countries. On the other hand, the bills used in effecting payment for our exports, whether they take the one form or the other, will reverse this relationship and place foreign banks in the debt of American.

5. **Clearing the accounts of the bankers in foreign exchange.** The cancellation of offsetting credits which results from bankers' transactions in foreign exchange must not be supposed to take place automatically, or even intentionally. On the contrary, each of the many bankers who engage in the business seeks a personal profit from his operations, and buys and sells bills of exchange with this profit in mind and not with a view toward the ultimate effect upon the relationships of the different markets as a whole. Nevertheless, these normal, profit-seeking operations of a multitude of individuals result in a cancellation of offsetting credits and a clearing of the accounts of the bankers so far as possible without the shipment of gold from one market to the other. To make this result clear, let us focus our attention upon the case of a typical dealer in foreign exchange operating in the New York market. This individual engages principally in two sets of transactions. The first of these is the buying of exporters' bills of exchange drawn upon the different markets of the world and the forwarding of these bills for acceptance and discount (or for collection) to foreign correspondents. This group of operations, as we have seen, creates for him supplies of funds in the different foreign cities where the bills are payable. The second set of transactions is concerned with utilizing these funds by drawing his own drafts against the balances held by his foreign correspondents and selling them in his market to those who have remittances to make. His

business is, of course, conducted on an immense scale and is concerned with a multitude of bills of every denomination and tenor; for each season brings a flood of bills into the New York market — bills drawn against our exports of food, cotton, machinery, copper, and other goods to the various markets of the world — and a constantly recurring demand for the banker's drafts from the importers of manufactured goods from Europe, or coffee from Brazil, or silk and jute from the Orient, or fruits and spices from tropical countries. Engaged in these two groups of transactions, our New York banker will, by one series of operations, constantly build up credits in London, Paris, Buenos Aires, and other foreign centers, and by the second series continually destroy these credits.

Now, the profit of this typical banker depends upon his avoiding, on the one hand, the creation of foreign credits in excess of his ability to use them, and, on the other, taking care not to find himself without a balance in a particular foreign center when a brisk demand for bankers' bills drawn upon this center arises. He must neither buy commercial bills much in excess of the demand for his own drafts against the same markets, nor fail to buy a sufficient quantity of these bills to meet a profitable demand for his own drafts. For his profit is drawn from a difference in his favor between the rates of exchange at which he buys and sells, and this profit cannot be gained from buying only, nor from selling only, but rather from a combination of purchase and sale. Left to his own devices, therefore, the banker's self-interest will impel him to clear his account with his foreign correspondents within periods as short as possible, else he must either find himself with idle funds lying in foreign cities or be compelled to forego opportunities to sell demand drafts at favorable rates because of a lack of these funds. A cardinal rule of his business will be the rule of *compensating purchase and sale*, or the maintenance of an equilibrium between the additions to, and subtractions from, his foreign balance.¹ No overseeing

¹ This practice of offsetting purchases of foreign bills by sales of foreign bills is a guiding principle of regular dealers in exchange, but it must not be understood that no exceptions to the practice are to be found. Moreover, the

of his transactions will be necessary to induce him to obey this rule within practicable limits, for his own self-interest will take care of that. Similar conditions will govern the operations of all other regular dealers in foreign exchange in New York and in the other markets of the world. Though not actuated by the purpose of clearing the accounts of all the banks as between the markets as a whole, nevertheless, each dealer will strive to keep his own relations with his foreign correspondents as free from excess credits as possible and the aggregate effect of their individual operations will be to clear the accounts of the markets.

If the typical dealer whose case we have been considering should find that he has been buying more sterling bills than he can utilize through the sale of his own sterling demand drafts to his business clientèle, and that, consequently, his balance in London is growing disproportionately large, he will attempt to sell demand drafts to other bankers in the New York market whose relation to London is the reverse of his own. This action will be tantamount to sharing his London credit with other bankers whose opportunities to sell sterling bills to the business world are larger than his own. Thus the aggregate sterling credit of the New York market will be apportioned among the banks of New York, until the demand of the market for sterling drafts is satisfied; or, in other words, until all possible opportunities for cancelling these credits against corresponding debits have been exploited. The same process will govern the dealings of the New York market in the bills of exchange of other countries, and the net result will be a clearing of all accounts so far as clearance is possible.

statement does not imply that dealers in exchange do not habitually carry balances to their credit in foreign centers, but only that they attempt to maintain these balances at a constant figure by offsetting credits and debits.

Two kinds of operations in foreign exchange are carried on by bankers at times, both of which require a surrender of the principle of equal purchase and sale. These are: first, *speculation* in foreign bills; and, secondly, *investment* in foreign bills. The condition of the exchange market which encourages these operations on the part of the bankers will be discussed at length in later chapters. But it may be said here that, in the common run of his transactions, and in all cases when he is acting solely on behalf of the seller or buyer of bills of exchange, the banker will govern his activities by the principle of compensating purchase and sale.

CHAPTER II

DEMAND AND SUPPLY OF BILLS OF EXCHANGE

OUR discussion in the preceding chapter was purposely limited to those bills of exchange which arise from the world's trade in commodities, whose function is to facilitate payment of money owed by the buyer to the seller of the goods. Though this is by far the chief use of foreign bills of exchange, many other transactions between individuals of different countries are constantly occurring to make a payment of money from one to the other either necessary or desirable. In all such cases there is opportunity to effect payment by the use of bills of exchange. The great current of bills which flows between the money centers of the world is engaged in clearing up millions of such payments, various in their origin and in their terms, between the citizens of the different nations; and the bankers of the money centers through whose hands these bills pass are engaged continually in buying the drafts of creditors upon their foreign debtors, and selling to debtors their own demand drafts for remittance to foreign creditors. Each exchange dealer attempts to bring his purchases and sales as nearly as possible into equilibrium, thereby reducing to the minimum the balance due between himself and his foreign correspondents. When this end can be achieved, the accounts of the different countries — including those of the bankers as well as those of the merchants — can be cleared without the actual transfer of money from one country to another. It is apparent, however, that this desirable result will come about only if the supply of bills offered for sale to all the bankers of each money center is roughly offset by the demand for bills from these bankers; for only under this assumption will it be possible for each dealer to balance his sales against his purchases and utilize all of his credits in foreign cities. It is the purpose of the present chapter to

inquire how far this equilibrium of supply and demand in the exchange market is possible, and what effects will be produced by it.

6. Sources of demand and supply of bills of exchange. International transactions in which bills of exchange are employed fall into the following principal groups:

- (a) International trade in commodities.
- (b) International purchase of services.
- (c) International trade in securities.
- (d) International payments of interest and principal due upon securities held by foreign investors.
- (e) International remittances for the use of travelers and foreign residents, by immigrants to their families and friends, and by governments for the support of their foreign representatives.
- (f) International transfer of liquid capital from banks in one financial center to those in another.

The first of these groups has already been discussed. We have seen that our export trade creates a supply either of commercial bills drawn by our merchants upon their foreign customers, or of bankers' bills to be received by our merchants from their foreign customers and cashed at our banks. The negotiation of both types of bills has the effect of transferring funds from our banks to those of foreign cities. On the other hand, our import trade either creates a demand for bankers' bills to be remitted by our merchants to foreign exporters; or else a supply of commercial bills drawn by foreign exporters, which bills, received by our banks from their foreign correspondents, are redeemed by our merchants at the offices of our bankers. Both modes of payment will cause a transfer of funds, the property of foreign bankers, into the banks of our country. The effect of our international trade in goods may therefore be summed up in a brief formula: our exports create foreign credits for our banks; our imports create similar credits in our country for foreign banks.

7. International purchase of services. Two forms of service, generally speaking, command an international market: the transportation of freight upon the seas, and the work

done by bankers and financing houses. When American business men purchase these, or other, kinds of service from foreigners, the effect upon the exchange market is the same as if these Americans had imported goods.

For the past half-century, goods entering or leaving American ports have been carried chiefly in ships of foreign register, and American traders have been under the necessity of paying foreign shipowners large amounts yearly on account of freight charges. Since the principal foreign marine companies maintain offices in the seaport cities of the United States, it has been the practice of our merchants to pay their freight bills at these local offices; but money thus collected must eventually be transferred from the branch to the home office, and the most convenient method of transfer has been the purchase and remittance of bankers' demand drafts. Thus the final clearing up of our obligations arising from the employment of foreign freight vessels has in the past given our bankers opportunity to draw their bills of exchange against credits provided for them in foreign cities by their purchase of the commercial bills of our exporters. The changes which have taken place during the Great War, however, have left the United States in possession of a merchant marine which ranks second in size among the freight carriers of the world. If this marine remains permanently under our ownership, our former demand for bills of exchange with which to pay for freight service will to a great extent disappear.

For reasons which will be discussed in a later chapter, London has, in the past, been the center of the world's business in foreign exchange, and because of their strategic position, London bankers have earned large amounts yearly in the form of commissions on transactions performed on behalf of bankers in other financial centers. The New York bankers, for example, have engaged more of this kind of service from banks and finance houses in London than they could offset by reciprocal services. Thus, at the end of each accounting period a balance has been due these London bankers on the score of commissions earned, which balance, if the accounts

of the two sets of banks had otherwise been cleared of debits and credits, has required a remittance of sterling bills. This form of service, then, has had an effect upon the exchange market of New York similar to that of marine transportation; that is, it has absorbed a part of the supply of bankers' bills drawn against the foreign credits created by our export trade. The spread of American branch banks in foreign countries and the increasing importance of New York as an international money center, both products in large part of the Great War, will tend to reduce this demand for bankers' bills in the future.

8. International trade in securities. When American stocks and bonds are sold abroad, the terms of sale ordinarily provide for draft upon the buyer drawn by the seller, the securities to be delivered upon payment of the draft. Thus a bond house or underwriting syndicate in New York which sells a block of stocks to an English investor will draw a sight draft for the amount of the sale. This bill of exchange will be sold in the New York market to a banker who also takes possession of the stocks as additional security in the transaction. The draft, endorsed to the London correspondent, is pinned to the securities and forwarded; upon its arrival in London, notice will be given the investor that he may obtain possession of his stocks upon payment of the draft, and when payment has been made the transaction will leave the two banks in precisely the same creditor-debtor relationship as that produced by our exports of merchandise.

Before the Great War, the annual investment of foreign capital in American industries gave rise to a large volume of such bills of exchange. It had become the practice of European finance houses to participate in underwriting syndicates formed in New York to float new issues of American companies, the purpose of the foreign financiers being to withdraw a portion of the issue from the American investment market and sell it among their own clients abroad. At the same time American bond houses were seeking independently to develop a market for our securities among foreign investors and succeeding in selling abroad yearly an aggregate

of large value. In 1910, according to the estimate of an eminent English authority, the value of English investments alone in American industries was more than three billion dollars, and annual additions to this investment were amounting to scores of millions. This immense traffic in American securities has added greatly to the supply of bills of exchange on our market. Since 1914, however, the investment of European capital in American industries has been negligible, and international trade in securities has accordingly ceased to affect our exchange market on the supply side.

Obviously, the purchase by Americans of foreign securities will affect the market for foreign exchange in a manner the reverse of that just discussed. Payment in this case will be effected by draft drawn upon the American buyer by the foreign seller of the stocks or bonds, or by remittance of bankers' demand drafts from this side, either of which methods of payment will place American banks in the debt of foreign by causing an inflow of funds here for the account of the banks abroad from whom the foreign seller receives his money. The customary procedure when placing a foreign issue of securities upon the American market is somewhat as follows: The services of an American banking firm are engaged for the purpose of underwriting and managing the sale; individual purchasers of the bonds and stocks pay this firm in dollars for the value of the securities they buy; and when the entire issue has been disposed of, the American bankers are in possession of a sum of money belonging to some corporation or business firm in a foreign country. Bankers' demand drafts may now be bought and sent abroad to transfer this money to its real owners; or, if it is the intention of the company issuing the securities to invest the proceeds in American goods, the money in the hands of the underwriting syndicate will be used to buy up the bills of exchange drawn by the exporters of these goods against the foreign company. In either case, when carried through to its conclusion, the sale of foreign securities to American investors will have resulted in an increase in the demand for some kind of foreign exchange in our market.

Before 1914, investment opportunities in the United States were so attractive that little American capital sought a foreign market; but during the war we departed from our normal practice and loaned billions of dollars to foreign governments. The whole of this vast sum was brought to bear upon our exchange market from the demand side in the manner discussed in the preceding paragraph, since the proceeds were used to finance our sales of munitions, foodstuffs, and other materials to the belligerent nations by taking up the bills of exchange drawn against these shipments by our merchants. During this period our exports of goods greatly exceeded our imports, and as a result the supply of commercial bills offered for sale to our bankers vastly outweighed the demand of our importers for the drafts with which the bankers sought to offset their purchases of exporters' bills. Without some compensating factor on the demand side of the market, our exporters would have experienced great difficulty in disposing of their bills of exchange; this compensating factor was supplied by our immense loans to the Allied Governments. It may be said of these loans, therefore, that because our Government, or its citizens, invested in foreign bonds, there resulted a demand for the commercial bills of exchange of certain other Americans which would not otherwise have existed. Since the war the favorable rates of exchange have encouraged a continuance of this form of investment in foreign countries and have kept alive the demand for foreign exchange in our market in the face of a continuing preponderance of exports over imports.

When securities owned abroad are either redeemed at maturity or resold by their owners to the country which issued them, the effect upon the exchange market is the opposite of that caused by the original sale. Suppose, for example, that American railway bonds worth \$10,000 come to maturity in the hands of an English investor and that the transaction of redeeming them is handled by the financial agents of the road — let us say by some Trust Company in New York. The redemption money will be deposited with the Trust Company, converted into sterling demand bills, and

sent over to a London correspondent. The English investor will then be notified to surrender his bonds to this London bank and receive the money due him, the bank having placed itself in funds to meet this expense by cashing the demand drafts received from New York. Maturities of this kind are frequently offset by refunding operations or by the sale of new securities to the foreign capitalist whose investment has reached its term; but if in a given year more American securities mature in the hands of foreign owners than are replaced by new issues, the net result will be a demand for foreign exchange in the American market. The same effect will follow the resale to America of American securities owned abroad. Such a selling movement attained vast proportions during the Great War when it was so essential for foreign peoples and governments to establish credits in New York; the effect of this movement was to increase the demand for foreign exchange in our market. Conversely, when foreign securities owned by the Government, or by private investors, of the United States mature or are resold abroad, the transactions will create a supply of foreign exchange here by reversing the series of operations just discussed.

There is a floating supply of standard stocks and bonds which appears for sale upon the stock exchanges, first of one country, then of another, and so exerts a varying influence upon the supply of and demand for bills of exchange. Stock brokers dealing in these securities keep close watch upon the quotations of the different exchanges, alert to buy in the cheaper and sell in the dearer market, thus influencing the balances due between the finance houses of the different centers. When, for example, some such stock is quoted a point lower in London than in New York, a brokerage house in New York which has London connections can buy a thousand shares on the London Exchange and sell them almost simultaneously on the exchange in New York, thus making considerable profit. Obviously, this transaction will call for a remittance of funds from the New York brokers to their London associates, and so create a demand for sterling bills in New York.

So alert are the arbitrageurs that a great discrepancy in the quotations of a standard stock on two exchanges can hardly occur, for the slightest divergence produces active buying and selling which soon corrects the discrepancy. This shifting of ownership in securities from one country to another often exerts an unforeseen influence upon the foreign exchange markets of the world. Because of the great amount of United States securities owned abroad, the New York market in times past has been subjected to sudden and violent increases in demand for foreign bills of exchange due to the resale of these securities on the Stock Exchange of New York. Any widespread desire on the part of foreign investors to release funds which they have invested here has brought these stocks and bonds home to our market in large volume and American bankers and brokers have been placed under the necessity of remitting the proceeds of their sale in the form of bills of exchange. These selling movements usually occurred when there was distrust abroad concerning the stability of our financial and industrial structure; thus a threat of panic in America has been certain to increase the demand for foreign exchange in New York through the medium of our stock markets. The closing of the New York Stock Exchange shortly after the outbreak of the Great War was a precautionary measure intended to forestall a dangerous selling movement of this origin.

The influence of international trading in securities upon the demand and supply of bills of exchange may be summarized as follows: The sale to foreign investors of securities from America, or the redemption by foreign companies of their securities owned here, causes a supply of bills of exchange in our market; the purchase by American investors of securities from abroad, or the redemption by American companies of their securities owned abroad, causes a demand for bills of exchange in our market. It should be made clear, however, that the exchange market is not affected in one way or the other by the *aggregate* of these foreign investments outstanding at any one time, but only by current additions to, or subtractions from, this aggregate. The ten billion dollars

owed by foreign governments to our own does not now, so far as the principal of the debt is concerned, exert any influence upon the exchange market; its effect was felt on the demand side of the market when the loans were made, and its influence upon the supply side of the market will be felt when the principal of the debt is repaid to our country.

9. **International payments of interest and dividends.** This is a secondary influence of trading in securities. These payments have the effect of increasing the demand for foreign bills when interest payments are being made by domestic companies to foreign investors, and the supply of bills when the payment is the other way. The actual process of handling these remittances may vary as between different transactions without altering their effect upon the exchange market.

For example, American companies which have a large number of stock and bondholders in England frequently employ a firm of London bankers to perform what is known as *service of loan* — that is, the redemption of interest coupons and the payment of declared dividends to stockholders of record. Let us suppose that a dividend is due upon a preferred stock of an American company and that some millions of dollars must be paid to English stockholders. These stockholders will be instructed to present their claims to the designated London house which is performing the service of loan, where they will be redeemed out of funds supplied by the company. Demand for sterling bills in New York will appear at the time the company remits these funds through their financial representative on this side. Similar payments made to American investors by foreign companies will have a reverse effect upon the market for foreign exchange in our country. For example, when the Allied Governments pay interest upon the bonds held by the United States, they will be compelled to place funds in this country to the amount of the payments due, and this they can do either by buying up bills drawn on American houses for remittance to our treasury, or by instructing our treasury to draw against deposits made by them in banks of their own countries. Either process will increase the foreign credits of

our banks. For a long time to come, because of the enormous holdings of these bonds in America, current interest payments must operate as an appreciable force upon the supply side of our exchange market.

10. Travelers' expenditures, immigrants' remittances, and the like create a demand in the country from which the remittances are made for the exchange of the country in which the money is spent. The American tourist usually supplies himself with funds before his departure by purchase of some form of bills of exchange — travelers' letter of credit or travelers' checks — from his banker; these he either cashes at the banking offices of foreign correspondents or transfers to hotel-keepers and others, by whom they are cashed. The effect of such transactions is similar to that of remittances of bankers' demand drafts by our importers of foreign goods; that is, exchange dealers in this country are given the opportunity to draw against their credits in foreign cities. Similar, also, is the effect of the remittances of immigrants whether these be made by postal money order or by bankers' demand draft. A postal money order bought by an Italian in New York and cashed by his relative in Naples, puts the United States Post-Office in the debt of the Italian. Eventually the balance due between the Governments on this account must be cleared up by remittance from this side. If the Italian immigrant had sent his money through an Italian banker in New York, the effect upon the exchange market would have been more direct, but not otherwise different. The banker in New York would have received the immigrant's money, his correspondent in Naples would have turned it over to the payee of the draft, and the transaction would have left the two banks in the same creditor-debtor relationship created whenever one bank sells bills of exchange drawn upon another.

The maintenance of diplomatic and consular services by our Government calls for the remittance of funds for the payment of salaries, rents, and other expenses. The amount of these remittances, though small relatively to the other forms of international payment, makes up in the aggregate a large absolute sum. In transferring funds abroad for this purpose,

the medium usually employed is a draft or order which, purchased on this side, will be redeemed in a foreign city. The fact that these funds are transferred on Government account in no wise differentiates their effect upon the exchange market; indeed, if the Government were to pay its expenses in foreign countries in Federal Reserve Notes or Gold Certificates, this mode of payment would none the less have the same effect as a demand for bills of exchange in our market. Paper money of this kind, lacking currency abroad, would collect in foreign banks and be sent back to New York for deposit with American correspondents of these banks. These credits would offset our bankers' balances in foreign countries precisely as if our Government had paid the money over to our banks in the first instance and received bankers' demand bills for remittance abroad.

11. Short-term loans between financial centers. There is in every financial center a varying amount of liquid capital employed solely in short-term loans. It happens at times that opportunities for profitable employment of these loan funds in the local market fall behind those offered by foreign financial centers. When this is the case, bankers in the two centers will shift a portion of this liquid capital from the poorer market to the better, effecting this transfer by draft drawn by the banker in the borrowing market upon the banker in the lending market. There are some technical features of the bills drawn in the course of these lending operations which distinguish them from other bills sufficiently to warrant the close and detailed examination which we shall give them in a later chapter; but since the effect of these bills upon the exchange market is the same, whatever their technical nature, we may in the present discussion consider them uniform.

To illustrate, suppose the discount rate in New York rises sufficiently above that in London to attract loan funds from the latter market. New York bankers will then, by agreement, draw sterling bills at sixty or ninety days' sight upon banks in London and sell them for dollars in New York. These bills will be sent over by the buyer and presented for

acceptance to the London banks upon which they are drawn, after which they will be sold in the London discount market, thus absorbing a portion of the credit of that market. In New York, the drawing banker will be in possession of funds which he may lend at the higher rate of interest prevailing here. When the bill matures in London, the loan may be extended by a repetition of the operation, thus creating a second sterling bill whose proceeds when sold in the London discount market will supply the funds for redeeming the original bill. Or, if the opportunity for profit has disappeared, the transaction may be closed out and the profit divided between the two bankers according to agreement previously made. In the latter case, the loan is withdrawn by the New York banker's buying sterling exchange in the market and sending it to his London correspondent in time to meet the maturing draft which originated the lending operation. Thus, when New York is borrowing on short term from London or other foreign centers, a supply of exchange is created in our market; when the loan is withdrawn, or when New York is lending in foreign centers, a demand for bills of exchange appears in our market. In the past, New York, though borrowing frequently and in large amounts from foreign cities, has rarely loaned abroad, since the discount rate in New York has rarely fallen below foreign money rates.

12. Summary of demand and supply factors of the exchange market. In summary it may be said that the supply of bills of exchange offered to dealers on the New York market, comes principally from the following sources:

- (a) The exportation of American goods.
- (b) The sale of American securities to foreign investors.
- (c) The payment of interest and dividends on foreign securities owned here.
- (d) The contracting by New York bankers of short-term loans in foreign money centers.

Each of these transactions has the effect of creating credits in foreign countries for American bankers. The demand for bankers' drafts drawn upon these credits comes principally from the following sources:

- (a) The importation of foreign goods.
- (b) The purchase of foreign freight and banking services.
- (c) Investment by Americans in securities sold by foreigners.
- (d) Payment of interest and dividends by American borrowers to foreigners.
- (e) Expenditures abroad by the American Government and tourists.
- (f) Repayment by New York of short-term loans contracted in foreign money centers.

This tabulation does not pretend to be exhaustive; many transactions, more or less unique in character, are continually occurring to create a demand for or supply of bills of exchange, but these are insignificant in comparison with the major forces at work. If we were to attempt to represent these forces during a given period in the form of an account, by crediting those transactions which increased the European balances of American banks and debiting those whose effect was to deplete these balances, the resulting account would be somewhat like that given in the accompanying table:

**TRADE STATEMENT UNITED STATES WITH EUROPE, JANUARY 1, 1919,
TO SEPTEMBER 15, 1920 ***

<i>Debits to U.S. banks</i>	(000,000 omitted)	<i>Credits to U.S. Banks</i>	
Merchandise imports.	\$1,805.00	Merchandise exports.	\$8,405.00
United States tourists.	75.00	Silver exports.	30.00
Immigrants' remittances .	450.00	Freight balance.	125.00
Loans by Government and people of the United States to Europe.	3,519.60	Ships sold to Europe.	20.00
American securities repur- chased.	200.00	European securities matur- ing.	1,135.00
Securities of other nations purchased from Europe.	101.00	Interest paid by Europe to people and Govern- ment of United States ..	391.00
Gold received.	183.00		
Total debit.	\$6,333.60		
Net credit.	3,772.40		
	<u>\$10,106.00</u>		<u>\$10,106.00</u>

* This statement is adapted from a table published by B. M. Anderson, Jr., in *The Chase Economic Bulletin*, October 5, 1920. Some of the figures are estimates, but the possibility of error involved in this fact does not disqualify the statement as an illustration of the forces at work in the exchange market.

Examination of this statement will show that the European credits of American banks during this period were produced chiefly by our immense exports of goods, the payment of interest by European debtors, and the repayment by these debtors of various portions of their debt to us, with smaller additions to the credits by reason of a freight balance, silver exports, and the sale of ships. The principal offsets against these credits were caused by our imports, various forms of investment in foreign securities, and the remittances of immigrants, with lesser effects of the same nature due to our receipts of gold and the expenditures of our tourists. The fact need not be emphasized that this statement relates to a time when conditions were very abnormal; evidence of this fact is to be seen in the tremendous favorable balance of trade, the abnormal amount of international trading in securities, and the uncanceled balance of almost three and three quarters billions of dollars. It must not be assumed that this uncanceled balance was left standing to the credit of American banks in foreign cities; the major portion of it was absorbed by American citizens and credit institutions through various forms of foreign investment which could not be traced and which, therefore, were omitted from the statement.

13. Balancing international payments by means of bills of exchange. When we view the foreign bill of exchange from the standpoint of the individual whose commercial transaction has been facilitated by its use, we discover that the prime function of the bill is *to substitute for a credit payable in a distant place, in a foreign coinage, and (usually) at a later date, funds payable in the creditor's locality, in the money of his own country, and (usually) available immediately.* Changing our point of view and considering the aggregate effect of dealings in foreign bills upon the different markets of the world, we discover that these bills have a *national* as well as an *individual* significance. The various sources from which are drawn the total supply of bills of exchange in the New York market have one characteristic in common: they all represent the sale by Americans to foreigners of goods, services, or property rights; and the various sources from which arises the demand

for bankers' bills in the New York market also have one characteristic in common: they all represent the purchase from foreigners of goods, services, or property rights. In so far as these many international transactions are cleared up by the use of bills of exchange without the transfer of money from one nation to another, the national significance of the exchange operations is this: *to enable the nation to pay with her goods, services, and property rights for her purchases of these things from the peoples of foreign nations.* Through the medium of bills of exchange international trade is reduced to barter.

To illustrate and make clear this important result of exchange operations, we may use our trade with Great Britain as an exemplar of our entire international commerce. We have seen that whenever payments are due Americans from persons in Great Britain on account of goods or property rights sold, or services rendered, the exchange bankers assume the right to receive these payments by taking up the bills of exchange of the American creditors and either advancing the money due or transferring it at the time of collection. On the other hand, whenever Americans have payments to make to persons in Great Britain, the bankers undertake to make these payments; they receive the American's money and either give him a bill of exchange payable abroad or present to him a bill drawn by the English seller. The exporters and other sellers in our international trade create for our bankers credits in London; our importers and other buyers avail themselves of these credits for making payments to English creditors.

If, now, our trade with Great Britain over a given period balances so nicely that the bills drawn by our exporters (and other sellers) exactly equal the demand from our importers (and other buyers), the accounts of the banks concerned in the transactions will balance. Under such conditions, whether we view the situation from the American or the British side, we may say that our foreign sales have paid for our foreign purchases. The function of the bankers will have been merely that of middlemen bringing exporter and im-

porter together so that the credit of the former in Great Britain could be used by the latter to pay his debt there. It is at least conceivable that the cancellation of international payments might have been accomplished without the aid of bankers. Let the American exporter draw on his English debtor and sell his draft directly to an American importer who needs a sterling bill; let the latter transfer his bill to his creditor, who may then collect the amount from the British exporter on whom the bill is drawn. By this arrangement the importers of each country will pay over to the exporters of their own country the money due the latter, and, assuming as we do, an equality of exports and imports, the accounts of the two nations will balance. The interposition of the bankers in the transaction is merely for the convenience of both parties. The fact that they do not sell to importers the same bills which they buy from exporters, but use these bills to create credits against which they draw their own drafts, in no wise alters the principle involved. Under the given conditions of equal purchases and sales, the financing of our trade with Great Britain, whether carried through with or without the aid of middlemen, will be consummated by the bartering of exports against imports.

The same principle of barter applies when we bring into the account all other transactions for which payment must be made between the two nations. Of these transactions some will be financed in such a way as to bring British banks into the debt of American, while the financing of others will use up these credits as bankers' drafts are drawn against them. If the accounts of the two nations come to a balance at the end of any given period without the shipment of money, it will be because all payments which Americans have owed Britons have just sufficed to offset payments which Britons have owed Americans, whatever the nature of the transaction for which these payments were due. Thus in the past, Britain has bought from us great quantities of cotton and foodstuffs each year and has paid for these things in part with her manufactured goods, in part with the services of her merchant marine and banking mechanism, and, in part by

cancelling interest and dividends which we have owed her. Her purchases from us, though effected by thousands of unrelated transactions between individual merchants, have all combined to give American banks credit in London, while the divers forms of service which she has rendered us, though similarly unrelated in detail, have also combined to exhaust these credits. No individual in either country who took part in the transactions between the two need have been aware of this outcome of his commercial operations. Each importer and exporter, each shipper and security-holder, each tourist and banker, may have conducted his transactions with reference only to his individual inclination or profit, yet, by adding to the supply of bills of exchange or to the demand, all of these individuals have coöperated to enable the two nations to reduce their commercial relations to a plane of barter.

The process of cancellation of debits against credits can, of course, never entirely clear up the trade statements of the two nations, for it is inconceivable that the commercial transactions between them could ever exactly offset each other. But where a balance remains uncanceled, the use of bills of exchange makes it possible to draw a third country and a fourth and fifth into the account to bring it more nearly to equilibrium. The United States has for years sold more goods to Great Britain than she has bought from that country, and, consequently, the supply of sterling bills in American markets has exceeded the demand of the buyers of English goods, services, and property rights. Our trade with Brazil and other South American countries, and with the Far East, has taken off a part of this surplus. Brazil, for example, normally imports from Great Britain more than she exports to her; consequently, her own export trade with England does not suffice to satisfy the demand for sterling bills in Brazil. We, on the other hand, have bought from Brazil more than we have sold her and have, therefore, been in her debt on the balance of trade. Thus a triangular situation has existed: we have had unused credits in England; Brazil has had need for these credits; and we have been in Brazil's debt.

By transferring a portion of our sterling credit to Brazil, we have paid our debt there and given her the means of paying her debt to England.

To illustrate by a practical example: Suppose a firm of coffee importers in New York to be under the necessity of remitting payment to the exporters in Brazil; this payment can be made in sterling bills, because the Brazilian's banker, having use for a credit in London, will buy the sterling bills from the coffee exporter. Hence the New York importer may go to his banker and by paying the amount he owes for the coffee either get sterling bills which he may send to his creditor in Brazil, or an authorization, issued by the banker in favor of the Brazilian, which will allow the latter to draw the sterling bills against the banker's credit in London. That is to say, the New York importer pays a New York banker for his coffee; the Brazilian exporter receives his money from that banker in Brazil who buys his sterling bills, and when the bills arrive in London, they are charged against the credit of the New York banker there. In essence what has happened is this: we have instructed Great Britain to discharge a portion of her debt to us by paying our Brazilian creditors. If we look only at that part of this transaction which takes place in New York, we shall see that the coffee importer is in reality paying some American exporter for goods which he sells to Britain; for the banker in New York is able to command a sterling credit in London because he has bought, or is about to buy, the sterling bills of exporters. And thus the sale of our goods to Great Britain pays a part of the debt we owe Brazil for our purchases there.

We have purposely avoided mention of the technicalities and the variations of procedure in these triangular exchange operations, for it is our present purpose to examine only their effect upon the markets of the nations as a whole. During the last years of normal trade preceding the Great War, a large proportion of all our imports from countries outside of Europe and Canada was paid in sterling bills. This widespread use of our credits in London as purchasing power in distant markets has been possible because of the ever-present

demand throughout the world for bills drawn on England, a demand to be attributed to the dominant position in international trade which London has enjoyed. In later chapters we shall study the causes of London's supremacy as well as the technical details of this exchange of credit; it is our present concern merely to note that this extension of our use of sterling bills has had its result in offsetting our exports to Great Britain against our purchases of goods, services, and property rights, not only from Great Britain, but from many other countries as well. So customary has the employment of bills of exchange become in international trade, and so highly perfected the mechanism of the exchange markets, that the whole world has been drawn together into a close association for the offsetting of debits and credits. Every resource for cancellation will be exhausted before any purchaser in international commerce, whatever his home or the home of his seller, is compelled to make payment by the shipment of money. Yet none of the parties to these countless transactions, with the exception of the bankers who act as middlemen, makes conscious effort to achieve this result. Each is left free to seek out his own advantage by buying and selling in the best markets and upon the best terms, and each makes use of bills of exchange only because by so doing his profit is increased. Out of this complex of individual transactions emerges for the nation the one final result: through the use of bills of exchange, her total credits from all sources and in all markets are offset as far as possible against the total of her debits from all sources and in all markets.

CHAPTER III

RATES OF EXCHANGE

14. **Determining factors of the rates of exchange.** The expression *rate of exchange* signifies the terms upon which bills payable in foreign moneys will be exchanged for dollars and cents. At the outset of our inquiry into the nature and significance of rates of exchange, it is necessary to emphasize the fact that no single rate can apply to all the varieties of bills which may be drawn in a designated foreign money. Foreign bills of exchange are not of uniform quality, like bank notes or treasury certificates; on the contrary, they are credit instruments whose value is influenced by the confidence of the buyer in their ultimate redemption by the drawee. Varying in the degree of risk attached to their purchase, as they of necessity do, they command prices which vary in conformity with the risk element. Moreover, in many cases the bill is so drawn that an interval of time must elapse between the outlay caused by its purchase and the income caused by its redemption, and the buying price must take account of the loss of interest due to this delay. When a single rate of exchange is spoken of as *the* rate, reference is had to that type of bill upon which these factors of risk and interest exert the slightest influence: namely, bankers' demand drafts. The demand rate of exchange is everywhere the governing rate of the market; all other rates are derived from it in conformity with the degree of risk and the loss of interest involved in the purchase of the bills to which these rates apply. Accordingly, in this preliminary discussion we shall use the expression *rate of exchange* to mean the terms upon which a banker will sell for dollars and cents his demand draft drawn upon a foreign country.

Under competition, a banker's selling rate for his foreign demand bills — called, in the parlance of the market, the

drawing rate for checks on the foreign city concerned — will represent his estimate of the desirability of the bill to himself. Now, there are two attributes of these foreign demand bills (it must be recalled that we have abstracted the factors of risk and interest) which affect their desirability to the dealers in the market. In the first place, the bill transfers ownership in a foreign credit which gives the owner the right to receive a foreign money; in the second place, this credit is situated in a foreign city and payment will be made in that city. To retain possession of the bill, therefore, means for the banker continued ownership in this foreign credit so situated. Over against the desirability of this ownership, the banker will set the compensation he will receive for drawing the demand bill; this compensation will consist in a payment made to him in his own money and at his own place of business. The pricing of the bill will, therefore, be the outcome of the balancing of these two sets of factors in the mind of the banker:

- (a) The intrinsic worth of the foreign coin *versus* the intrinsic worth of the domestic.
- (b) The usefulness of funds in a foreign city *versus* the usefulness of funds at home.

To illustrate, assume that a banker in New York is asked to sell for dollars a demand bill calling for the payment of two thousand pounds sterling in London; how can he intelligently set a price on the demand bill? Obviously, he must take account of the two factors we have mentioned; that is to say, he must consider how the intrinsic value of the gold sovereign compares with that of the gold dollar, and, also, how much two thousand gold sovereigns are worth to him in their present location in London, as compared with the worth to him of their equivalent in New York. Let us assume for the moment that the location of his funds is a matter of indifference to the banker. Under this assumption, the sale of a demand bill will represent a simple conversion of one kind of money into another; the banker's problem would not be different if gold sovereigns and gold dollars were lying in two heaps upon his counter and he were asked to exchange

two thousand of the one for their equivalent in the other. The banker's rate of exchange would merely express equivalence between the intrinsic values of the two kinds of money; this rate would be called *par of exchange* in the market.

But we have only to make this assumption to realize that it is very far-fetched. It can never be a matter of indifference to the banker whether his funds are at home or in a foreign city; it is, on the contrary, sometimes more, sometimes less, desirable for bankers in New York to have funds under their control in London, and, as a consequence, the bills of exchange which affect the amount of these funds are more willingly sold at certain times than at others. Reflecting this difference in his willingness to sell, the banker will offer his bills at rates of exchange which deviate from par, either rising above or falling below the point which expresses equality between the two systems of coinage. Both attributes of the foreign bill of exchange — the fact that they effect the exchange of one kind of money for another, and the fact that they decrease the seller's funds in a foreign center — must be taken into account when attempting to explain the rates which rule the market, for each has its distinctive part to play in determining these rates. In brief, the influence of the two factors may be expressed as follows: the *money factor* of a given bill determines the *par rate* for that bill; the *location factor* determines the *daily fluctuations* of the rate above and below par.

15. Money factors and the mint par of exchange. Each coinage system of the world has its own peculiar mint par of exchange with the coinage system of the United States, the quotation in each case expressing equivalence between the intrinsic values of the standard foreign coin and the dollar. From the point of view of their systems of coinage, the trading nations of the world may be divided into three groups: first, and most important, is that group of the most powerful and most advanced of the nations, whose monetary system is based on the gold standard; secondly, a considerable group of less progressive nations whose standard coin is made of silver; thirdly, a group of nations whose monetary systems,

temporarily or permanently, are composed of an irredeemable paper money. Among these groups of nations there are three major combinations to be considered: (A) par of exchange between two gold standard countries; (B) par of exchange between a gold standard and a silver standard country; (C) par of exchange between a gold standard country and a country using an irredeemable paper money. The other three possible combinations — pars between two silver standard countries, two paper standard countries, and a silver and a paper standard country — need not be considered at length, since the principles which determine these pars may be derived from those governing the three major combinations.

The *standard money* of any system is that kind of money in which all other kinds are made redeemable by the law of the nation. The other forms of money which comprise the system may be grouped together under the term *fiduciary money*, since they depend for their currency and their value upon the faith of the people in their redeemability in the standard money at the option of the holder. If the standard money is composed of metal, the size, weight, and fine metal content of the coin will be fixed with great precision by the coinage laws of the nation; if paper is the standard, the description of the standard note will be similarly fixed by law. In addition to these two kinds of money, the circulating medium of most countries contains a number of other things which are not money at all, but which, nevertheless, do the work of money with more or less efficiency; chief among these are bank deposits subject to check. The value of these non-monetary kinds of currency is, likewise, dependent upon their convertibility into the standard money of the system. So long as the nation adheres faithfully to its standard — that is, so long as it continues freely to redeem all kinds of money in standard money on demand — the various coins and notes which compose its system will have a uniform value and will be accepted by the people with no other discrimination than that based on the convenience of handling them. To maintain a gold standard, then, a nation need not use gold money as its

sole, or even as its chief, medium of exchange; in fact, it may effect its exchanges through a medium which is not money at all, but currency. It is sufficient to characterize a nation's monetary system as a gold or silver standard system when the values of all other kinds of money are kept at par with that of the standard money by reason of the instant and continuous convertibility of the former into the latter.

(A) *Mint par of exchange between two gold standard countries.* Gold and silver are commodities in international commerce essentially similar to all other commodities. In selecting gold as the standard of its monetary system, a nation merely prescribes that a certain amount of this commodity, of a certain specified degree of fineness, shall be contained in the standard coin. Unlimited and unrestricted minting of gold into coins of the prescribed weight and quality, at the option of the owners of gold, brings it about that the standard coin of the system has the same value in the form of bullion as it has in the form of money; that is to say, this standard coin when full weight (not abraded by much use) may be melted down into raw gold without loss of value. As a consequence of this fact, a standard coin of gold is an exportable article which may be sold outside the boundaries of the nation as a bit of precious metal whose quantity and quality are certified. The standard coins of two gold standard countries may best be considered simply as two different quantities of the same metal; they will exchange for each other on the same principles as those which govern the exchange of bushels of wheat for pecks of wheat, or of ounces of platinum for pounds of platinum. Par of exchange between two gold standard countries is, therefore, determined by the laws of arithmetic; the rule for this par of exchange may be stated as follows: between two gold standard countries, *par of exchange is determined by computing how many units of one standard coin are required to supply the fine gold content of one unit of the second standard coin.* The same formula may be used to determine the par of exchange between two silver standard countries.

The principal ^{gold} gold standard countries of the world are the

United States,¹ England and her Australasian colonies, France¹ and certain countries which have based their monetary system on the French unit of coinage, Germany and Japan. The standard coins of these nations conform to the following description:

<i>Country</i>	<i>Name of standard coin</i>	<i>Gross weight in grains</i>	<i>Degree of fineness</i>	<i>Weight of pure metal in grains</i>
United States..	dollar	25.8	9/10	23.22
Great Britain ..	pound sterling	123.274	11/12	113.0016
France.....	franc	4.978	9/10	4.4803
Germany.....	mark	6.1458	9/10	5.5313

The English monetary system is divided into the following parts:

- 1 pound equals 20 shillings
- 1 shilling equals 12 pence.
- 1 penny equals four farthings.

The symbols which represent these different kinds of money are somewhat peculiar. The sum, one pound, one shilling, and one penny is written, £1 1s. 1d. or, £1 1/1. The Australasian colonies of Great Britain use the same monetary system and the same symbols when expressing the system in figures.

The French monetary system is divided as follows:

- 1 pound (napoleon) equals 20 francs.
- 1 franc equals 100 centimes.

There is also a silver piece of five francs which is not redeemable by law in standard gold, but which is maintained at

¹ Both the United States and France have a qualified gold standard. In each of these countries there are silver coins — the dollar and the five-franc piece, respectively — with full legal-tender value whose redemption in gold is not expressly provided by law. In the United States, however, the silver dollar is kept at par with the gold dollar by the operation of the law of 1900 which binds the Secretary of the Treasury to maintain this parity; in France a similar parity is maintained by the practice of redeeming the silver in gold. The coinage of both of these silver units is limited by law.

parity with the gold coins by reason of the fact that the mints are closed to the coinage of silver and the Bank of France in normal times freely redeems the five-franc piece in gold. The systems of the following countries are based nominally upon the French unit of coinage, though in some of them the gold standard is of theoretical importance only, since the actual medium of exchange is an inconvertible paper money.

<i>Country</i>	<i>Name of coin</i>	<i>Relation to franc</i>
Switzerland.....	franc	same weight
Belgium.....	franc	same weight
Italy.....	lira	same weight
Spain.....	peseta	same weight
Greece.....	drachma	same weight
Bulgaria.....	leva	same weight
Servia.....	dinar	same weight
Rumania.....	leu	same weight
Venezuela.....	bolivar	same weight
Argentina.....	peso	5 times the weight
Paraguay.....	peso	5 times the weight
Ecuador.....	sucre	2½ times the weight

The German coinage is divided as follows:

1 pound equals 20 marks.

1 mark equals 100 pfennigs.

In all of these countries there is subsidiary and token money of silver and other metals, as well as paper notes representing different units of the standard money. In all of them, however, with the exception of the 5 franc silver piece of France, the different notes and coins are legally redeemable in gold and are maintained at a parity with gold by virtue of this redeemability. It need hardly be urged that these statements take no account of the collapse of the monetary systems of the world which has resulted from the war.

Given the weights of the standard gold coins in the different countries, their mint pars with the dollar may be derived by a simple process of division. The gold dollar contains 23.22 grains of fine gold; the pound sterling, 113.0016 grains of fine

gold. Hence, par of exchange between the United States and Great Britain is:

one pound sterling equals \$4.8665.
 $(113.0016 \div 23.22 = 4.8665.)$

The franc contains 4.48035 grains of fine gold; the dollar, 23.22 grains; hence, par of exchange with France is:

one dollar equals 5.1826 francs.
 $(23.22 \div 4.48035 = 5.1826.)$

The mark contains 5.53134 grains of fine gold; the dollar, 23.22 grains; hence, par of exchange with Germany is

one dollar equals 4.1979 marks.
 $(23.22 \div 5.53134 = 4.1979.)$

These pars will remain unchanged so long as the nations concerned do not alter their mint laws so as to change the fine metal content of their standard coins.

The mint pars between the United States and the principal gold using countries are given in the following table in the form in which they are usually expressed.

<i>Country</i>	<i>Pars of exchange with the United States</i>
England.....	\$4.8665 equals 1 pound sterling
Germany.....	\$23.83 equals 100 marks
Spain.....	\$19.30 equals 100 pesetas
Holland.....	\$40.20 equals 100 guilder
Scandinavia.....	\$26.80 equals 100 kronen
Japan.....	\$49.85 equals 100 yen
Argentina.....	\$42.44 equals 100 pesos
Brazil.....	\$32.44 equals 100 milreis
France.....	5.1826 francs equals \$1; or, 19.3¢ equals 1 franc
Italy.....	5.1826 lire equals \$1; or, 19.3¢ equals 1 lira
Switzerland.....	5.1826 francs equals \$1; or, 19.3¢ equals 1 franc
Belgium.....	5.1826 francs equals \$1; or, 19.3¢ equals 1 franc

Without variation in the method of determining the mint par of exchange between gold standard countries, the form in which the quotation appears may vary. Some financial journals in the United States, for example, customarily quote

par of exchange with Germany and Spain in so many cents per mark or peseta; and others, in so many marks or pesetas per dollar; both of these forms differ from the par as expressed above, where these currencies are quoted in units of one hundred. It is necessary for the student, in reading these current quotations, to inform himself as to the method of quoting par employed by each particular journal, otherwise he will be confused by the lack of uniformity among the quotations. In the New York market, two different methods are employed in quoting par of exchange between the dollar and other gold coins. Sometimes — as in the case of England, Germany, Spain, Holland — the foreign coin, or a multiple of the foreign coin, is taken as the unit and this unit is quoted in dollars and cents; in other cases, as in French, Italian, Swiss, and Belgian exchange, the dollar is taken as the unit and is quoted in the foreign coin. From this difference in method, confusion sometimes arises in interpreting a quotation which expresses a discount or a premium. In sterling exchange, for example, 4.8665 is par, 4.85 is below par, and 4.87, above par, the higher figure indicating a premium and the lower, a discount. This is true because, since pounds are quoted in dollars, a rising figure shows that they are becoming dearer and a falling figure that they are becoming cheaper. But in franc exchange 5.1826 is par, 5.17 is above par, and 5.19 below par. Here the higher figure expresses a discount and the smaller a premium, for it is the practice of the market to sell francs by the dollar's worth, and a rising quotation shows that francs are becoming cheaper in terms of dollars, while the reverse is shown by a falling quotation. A little care taken at the outset to acquaint one's self with the practice of the exchange market with regard to the form of quotation employed for the different currencies will guard against any misconception of this practice.

(B) *Between a gold and a silver standard country*, the par of exchange cannot be derived from the relative weights of the two standard coins. One grain of gold will always exchange for another grain of the same degree of fineness, but no such equivalence exists between two different metals, such as gold

and silver; hence, there can be no fixed parity between the weight of gold in one coin and the weight of silver in another. In the bullion market the price of silver in terms of gold fluctuates continually under the varying forces of demand and supply; the gold prices of silver coins change in harmony with these fluctuations, and constant revision is necessary to correct the par of exchange between the United States and the silver standard countries. To illustrate: the tael of Shanghai contains 516.4058 grains of fine silver; assuming that silver sells for one dollar per fine ounce (480 grains), the silver content of the tael is worth \$1.074. But when the price of silver rises to \$1.25 per fine ounce, a new par of exchange between the tael and the dollar results: namely, 1.342; while a fall in the price of silver to \$.75 will reduce the par of exchange with Shanghai to \$.806. These changes in the silver pars contrast with the relative fixity of the pars of exchange between the dollar and the standard coin of gold standard countries. When two coins contain the same metal, par of exchange between them can be altered only by revising the coinage laws of one country, or of both, so as to change the weight of the metal content of the coins; when the two coins are of different metals, however, par of exchange varies with each fluctuation of the market values of the metals, as well as with each alteration in the weights of the coins.

Because of the disturbance caused by this shifting of the exchange values of gold and silver coins, and of the realization that of the two metals gold is relatively the more stable in value, most nations have discarded the silver standard of coinage. Others, retaining an apparent silver standard, have adopted measures to bestow upon their coins a fixed ratio of exchange with the gold coins of other nations. The device most frequently and effectually employed to produce this fixed par between gold and silver coins is the *gold exchange standard*; we must postpone a discussion of this standard to a later point in this chapter, since an explanation of it can hardly be made until some attention has been paid to the specie points in the rates of exchange.¹

¹ See section 19.

China remains the only country of importance in international commerce whose standard money is composed of silver. But it is impossible to attempt description of the complex monetary system of China; indeed, the term *system* is a misnomer when applied to Chinese currency, for there are, in reality, many different systems in operation in the different trading centers of the country. Of these systems the coins most frequently quoted in the foreign exchanges are the tael of Shanghai and the Mexican dollar of Hongkong. The former is not, strictly speaking, a coin, but a unit of weight; money payments when measured in taels are usually made in the form of fine silver bullion made up into ingots (called *shoes*) each weighing fifty taels. The weight of fine silver in the tael is 516.40584 grains; a full-weight Mexican dollar contains 377.18098 grains of fine silver.

In recent years, so rapid have been the changes in the gold price of silver that pairs of exchange between the United States and silver standard countries have been subject to almost daily fluctuation, and, as a consequence of this condition, it has become the practice of the exchange market either to quote the silver exchanges as if no par existed or to assume a nominal par which corresponds but roughly with the true par of exchange at the time. Thus, on June 16, 1920, New York quoted the Far Eastern exchanges as follows:

Hongkong 76.50¢ per Mex. \$1.
Shanghai 101.00¢ per tael.

Standing by itself, this quotation does not inform the reader whether exchange drawn on these centers on this day stood at par, at a premium, or at a discount; this can be discovered only by computing the true par for the day from the price of silver in the market and the weight of fine metal in the tael and the Mexican dollar, and then comparing this par with the quotation given. The influence of the varying price of silver upon the daily quotations and the par of exchange between New York and Shanghai is disclosed by the table below.

<i>Date</i>	<i>Price of silver per fine ounce in New York</i>	<i>Market quotation Shanghai Exchange in New York</i>	<i>Par of exchange determined by price of silver</i>
June, 1915.....	\$.510	56.50	54.774
June, 1916.....	.681	72.00	73.139
June, 1917.....	.875	90.36	93.975
June, 1918.....	1.071	113.50	115.02
June, 1919.....	1.181	127.00	126.909
June, 1920.....	.90	101.00	96.66

Attention is called especially to a comparison of the fourth column of this table with the second column; this comparison will disclose how the par of exchange between gold and silver standard countries varies in conformity with variations in the price of silver. As silver rose in price during the years 1915-19, par of exchange with Shanghai also rose; with the fall in the price of silver which occurred between June, 1919, and June, 1920, par of exchange also fell. During this time, the actual quotation on Shanghai bills appearing in the New York market (see column three) was insufficient of itself to give the reader information as to the true state of the Far Eastern exchanges.

(C) *Par of exchange between a gold standard country and a country using an irredeemable paper.* Some nations of the world with monetary systems theoretically based upon a gold standard employ solely a currency composed of paper which is redeemable in no standard metal. These notes, whose only power in exchange is bestowed upon them by the receiver's faith in their ultimate redemption, have a value governed by their quantity; it is possible by carefully restricting their issue to give them a reasonably stable exchange value within the boundaries of the nation. But this achievement is rarely met in history. The ease with which the notes are printed and the inertia of Government which tempts to their use as a substitute for taxes or for economy in governmental expenditures, almost invariably lead to an excessive issue. Under the operation of Gresham's law, which states that a cheaper

money invariably tends to drive a dearer out of circulation, the paper expels gold from the circulating medium of the country which issues it. If the paper money is issued in sufficient amounts, no gold will be left in circulation; and if the issue is continued beyond this point, it will cease to exchange on equal terms with the gold coins whose name it bears — that is, a premium on gold will appear. When this stage is reached, it is customary to speak of the fiat paper as *depreciated in value*. In every nation whose money system, at this time (1921), is composed of irredeemable paper, this condition of depreciation has run to lengths more or less extreme.

Irredeemable paper money has no currency outside the boundaries of the nation which issues it; no par of exchange can be established with the gold coins of other nations until the paper has been turned into gold upon terms governed by its own depreciation. In quoting bills of exchange drawn in these paper units, it is the custom of the exchange markets of gold standard countries to proceed upon the assumption that a nominal gold standard exists in the paper-using country, and to quote the paper bills at rates which appear as a discount from a nominal gold par. But, strictly speaking, the depreciated paper is an essentially different unit from the gold coin whose name it bears, and the old par of exchange, which expressed equivalence between that gold coin and another gold coin, cannot be held applicable to it. A new par of exchange must be derived for each successive stage in the depreciation of the paper money. In determining this new par, account must be taken of two possible conditions obtaining in the paper standard country: (a) the paper country may be able to supply gold for export at a premium in terms of the depreciated paper; (b) the paper country may be either unwilling or unable to exchange gold for its paper notes in appreciable amounts upon any terms. The method of determining the par of exchange between gold coins and the fiat paper is governed by these two conditions.

When a country whose money consists of a depreciated paper is still exporting gold when required to do so, the new

par of exchange between her paper money and the gold coins of other nations may be computed with sufficient accuracy for all practical purposes from the premium on gold which exists in her market. Moving freely in international trade, gold serves as a common denominator for the values of different moneys; and the terms upon which gold bullion will exchange for the irredeemable paper will serve as an index to the ratio of exchange between this paper money and the gold coins of other countries. For example, if sterling bills are bought in the United States at a time when these bills will be redeemed in paper, but when gold may be obtained for export in England, the purchaser will pay for these bills with dollars each of which may be viewed as 23.22 grains of fine gold; the paper pounds received in payment of his sterling bills in England may be turned back into gold upon terms governed by the premium on gold in England. To buy these bills at par, the purchaser must receive enough paper pounds when they are redeemed to command in the bullion market of London the same amount of fine gold as he expends in purchasing them. The premium on gold will disclose the discrepancy between the paper pound and the gold pound, and will, therefore, indicate to what extent the old par of exchange must be corrected to express equivalence between the gold dollar and the irredeemable paper. If the premium on gold in England should be 100 per cent (that is, if the paper pounds were worth 50 per cent of their nominal gold equivalent), the new par of exchange on sterling bills would be 50 per cent below the old par: \$4.8665 exchange at par with one pound sterling because, as we have seen, each of these amounts of money contains 113.0016 grains of fine gold; when two paper pounds are required to buy this amount of fine gold, each will obviously be worth in gold dollars one half as much as the pound sterling. As the premium on gold rises or falls in England, par of exchange between the irredeemable paper and the dollar must be corrected accordingly.

A striking illustration of the effect of an irredeemable paper money on the par of exchange is to be found in the case of those countries which, after a prolonged experience with an

irredeemable paper, have adopted a fixed rate of conversion between the gold and the paper units of their coinage systems. In Argentina, for example, the unit of coinage — the peso — has in its gold form a par value in United States coin of \$.965. But for a long period of time the circulating medium of Argentina was composed of fiat paper money, irredeemable and greatly depreciated, which was finally made convertible into gold at the rate of \$.424 per peso. Following this action of the Argentine Government, there were two pairs of exchange between the United States and Argentina:

\$96.50 equals 100 pesos (gold).

\$42.40 equals 100 pesos (paper).

Whenever the conversion law of Argentina is changed, or unenforced, new pairs of exchange between the dollar and the paper peso must be derived to coincide with the depreciation of this paper unit in terms of the gold unit whose name it bears.

Thus far, we have been considering only that condition under which gold is permitted to flow between nations, being neither prohibited by governmental policy nor prevented by economic necessity from leaving the paper money country. But the expulsion of gold by the paper money, coupled with the unfavorable balance of trade induced by the rising prices of the paper money country, may cause so great an outflow of gold in the channels of international commerce as to exhaust the gold stock of the country and leave no more available for export. When gold does not function as an offset to the balance of payment, it loses its significance as a common denominator for the relative values of the standard coins of different countries. To the buyer of franc or sterling bills in the New York market, the premium on gold in France or England is of no significance if it is actually impossible for him to turn his bills of exchange into gold upon any terms. When these nations are on a paper basis and gold cannot be obtained for export, bills payable in their markets will be redeemed in paper money, and the paper money must

be spent within the country, since it has no currency elsewhere. The buyer in New York will pay for his bills in gold money whose value is determined by its purchasing power over American goods; he will receive, when his bills are redeemed, paper money whose value is determined by its purchasing power over the goods of the country which has issued it. In this situation there is only one accurate method of determining the par of exchange between the two countries, namely, by a comparison of their relative price levels.

To throw our problem into clearer light, it may be repeated that, in the absence of a common denominator in which to express the relative values of the two moneys, we are compelled to derive their par of exchange by comparing the purchasing power of one with that of the other. The purchasing power of money is, of course, a reciprocal of the general price level; that is to say, when all prices are rising, the purchasing power of money is falling *pari passu*, and when all prices are falling, the purchasing power of money is rising proportionately. Hence, taking England and the United States as our examples, by comparing the trend of the price level in the United States with the trend of the price level in England, we can compare changes in the purchasing power of the dollar with similar changes in the purchasing power of the pound during the years under observation. To avoid going too far afield in our discussion of this problem, we may assume that a reliable index number is devised which makes the trend of prices in the two countries comparable with each other. If, now, we discover by using this index that the price level in England has risen twice as far as the price level in the United States since 1914, or, to state the same fact in another manner, that the purchasing power of the pound has fallen twice as far as the purchasing power of the dollar, we may conclude that half as many dollars are now required to express the equivalent of the pound as normally. In this case the ratios of the two price levels is as 1:2; and the old par of exchange must be multiplied by this fraction to bring it into conformity with the altered purchasing powers of the two moneys. While these conditions remain true, the par of ex-

change between the dollar and the pound, formerly \$4.8665 per £1, becomes \$2.43325 per £1.¹

We may illustrate this method of obtaining the purchasing power parities of different coins when gold has ceased to function as a common denominator by referring to the trend of prices in the United States in comparison with the trends in Italy, France, and England since 1913. An index number, constructed from the same group of commodities in each country, and based upon a common year, shows the following price changes at the end of the year 1920:

<i>Country</i>	<i>Base year 1913</i>	<i>Index numbers December, 1920²</i>
United States.....	100	200
Italy.....	100	650
France.....	100	450
England.....	100	250

Prices in the United States had doubled between these two dates; in Italy, they had risen six and one half times; in France, four and one half times; and in England, two and one half times. On the basis of these facts, how can we determine the purchasing power parities of the dollar with the lira, the franc, and the pound, respectively, in December, 1920? Assuming that the gold parities and the purchasing power parities of the dollar with these coins were identical in 1913, we correct the gold parities on the basis of the difference in the price changes in these countries. The ratio of the rise of

¹ It may be well to point out that this calculation of the current par of exchange with a nation using a depreciated paper money is accurate only if based upon a year when the mint parities and the purchasing power parities of the two coins were identical. If the normal par of exchange failed to express the purchasing power parity, a fundamental error would be involved in the calculation which would vitiate its results. The index number constructed for this purpose must take account of this necessity.

² The price levels in all countries were changing rapidly at the time chosen for illustration. This introduces an element of uncertainty into the data from which the index numbers were computed. Since these figures, and the conclusions derived from them, are used merely for purposes of exposition, it has been thought best to disregard this error and be content with approximate results.

prices in the United States to the rise of prices in Italy, as shown by the table above, was 200:650; with respect to France, this ratio was 200:450; with respect to England, 200:250. These ratios are equivalent to the following fractions:

United States and Italy, $200:650 = 4/13$

United States and France, $200:450 = 4/9$

United States and England, $200:250 = 4/5$

The gold pars of exchange are corrected to conform to this condition of irredeemable and depreciated paper money by multiplying them by these fractions, as follows:

<i>Country</i>	<i>Gold par of exchange with dollar</i>	<i>Ratio of price changes in U.S. to price changes in given country 1913 to Dec. 1920</i>	<i>Purchasing power par with dollar December, 1920</i>
Italy.....	\$.193	4/13	\$.0593
France.....	.193	4/9	.0857
England.....	4.8665	4/5	3.8932

In the general confusion of the exchange market which results from the collapse of the monetary systems of a group of countries, misleading conclusions are frequently drawn regarding the effect of current exchange rates upon international commerce. The exchange market quotes bills drawn in depreciated paper at rates which sometimes register extreme discounts from the normal gold pars and no attempt is made to indicate what part of this discount is a *true* discount — that is, a discount from the new pars of exchange — and what part is to be attributed to the dislocation of the old pars. The necessity of guarding against this error may be illustrated with reference to the conditions we have been discussing. On December 10, 1920, exchange on Italy was quoted in New York at .035; exchange on France, at .0586; exchange on England, at 3.4475 (these quotations, of course,

are expressed in units of the dollar). The following table contrasts the apparent and true discounts on lira, franc, and sterling exchange registered by these quotations on December 10, 1920:

<i>Country</i>	<i>Rate of exchange Dec. 10, 1920</i>	<i>Purchasing power par of exchange</i>	<i>Current quotation discount from gold par (per cent)</i>	<i>Current quotation discount from purchasing power par (per cent)</i>
Italy.....	\$.035	\$.0593	81.8	40.9
France....	.058	.0857	70.	32.4
England...	3.4475	3.8932	29.1	11.5

The last two columns of the table give the percentage of discount below the gold par and the purchasing power par shown by the rates of exchange on the date given. It will be seen at once that, although bills drawn in lire, francs, and pounds sold at a true discount on this date, the discount was less than half as great as might have been inferred from a comparison of the quotations with the nominal pars for these moneys.

This subject of the effect of a depreciated paper upon the rates of exchange has been given a somewhat lengthy treatment because of the great importance at the present time, and the promise of continued importance in the near future, of correct thinking upon this matter. In a later chapter,¹ it will be shown that fluctuations of the rates of exchange exert a stimulating or depressing influence over the export and import trade of a nation; failure to distinguish between true fluctuations of the rates and movements of the pars of exchange under the influence of the money factor has induced many countries to adopt ill-conceived and mischievous policies of interference in the currents of international commerce. For the sake of additional emphasis, a graphic illustration is given on page 59 of the tendency of the exchange rates to conform to the purchasing power parities of the different national moneys. The fact that the

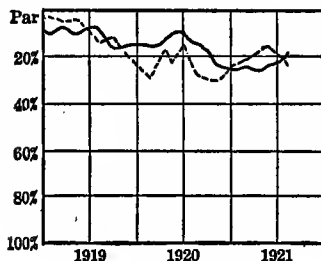
¹ See Chapter V.

FORM 3

DEPRECIATION OF FOREIGN EXCHANGE COMPARED WITH DEPRECIATION OF FOREIGN CURRENCY

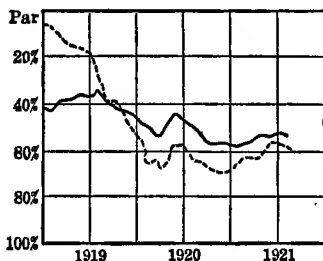
The par line represents the value of the dollar; the quotations on foreign exchange are plotted as percentages of the normal par with the dollar; the purchasing power of the foreign currency is plotted as a percentage of the purchasing power of the dollar.

The solid line, therefore, represents the purchasing power parity of the dollar with the given foreign currency; the broken line should be compared with this.



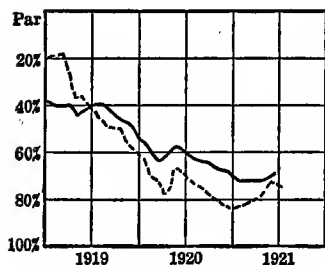
England

----- Exchange quotations
 ——— Purchasing power of currency



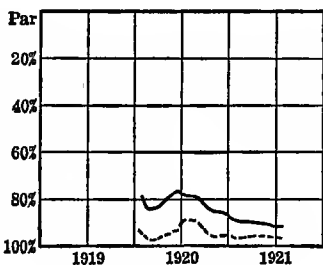
France

----- Exchange quotations
 ——— Purchasing power of currency



Italy

----- Exchange quotations
 ——— Purchasing power of currency



Germany

----- Exchange quotations
 ——— Purchasing power of currency

discount on lira, franc, mark, and sterling exchange, as shown by the broken curves, tended, during the period reviewed in the illustration, to conform to the changes in the purchasing power parities of these moneys with the dollar, as shown by the solid curves, is evidence that the gold pars of exchange no longer apply when a nation's standard money is an irredeemable paper.

In summarizing this discussion, it may be said that there are two possible ways of determining par of exchange between a gold standard and a paper standard country: (a) a correction of the gold par by utilizing the premium on gold in the paper country; (b) a correction of the gold par by multiplying it by the ratio of the purchasing power of the gold coin to the purchasing power of the irredeemable paper, both purchasing powers being derived from a common index number. Substantially accurate results may be obtained from the first method when the paper money has not long been depreciated and gold is available for exportation in the paper standard country. When depreciation of the paper has run to extreme lengths, and the paper standard country cannot supply gold for exportation, the second method will give the more accurate results. It may be added that between two paper standard countries, the only reliable method of determining par of exchange is the purchasing power method.

16. **Market fluctuations of the exchange rates.** So rarely are bills of exchange bought and sold at par in the market that many business men who have daily transactions involving the purchase and sale of foreign bills are ignorant of the fact that fixed pars exist. What has been called the location factor of the foreign bill — that is to say, the power of the bill to increase or diminish the holder's supply of funds in different geographical centers — so influences its desirability to buyer and seller as to prevent its changing hands upon terms which express equality between the two systems of coinage. It is this fluctuating desirability of foreign funds which accounts for the daily fluctuations of the exchange rates.

In explanation of the influence of this factor upon the daily

quotations of exchange rates, let us return to the effect upon the relations of the bankers caused by the buying and selling of sterling bills in the New York market. When a banker in New York buys a sterling bill of exchange, he virtually transfers a portion of his funds to London; when he sells a sterling bill, he returns these funds to his own vaults. Now, it is obvious that the only motive which can cause a New York banker to place funds in London will be the desire to make a profit by employing them there; and in foreign exchange this employment takes the form of bills drawn against the fund and sold in the bankers' market. Hence the desirability to the banker of a sterling bill which will increase the amount of his London credit will depend upon his opportunities for selling sterling demand drafts in New York. If his London balance is outstripping the market for his sterling drafts, he will be reluctant to buy and eager to sell bills drawn on London; while if the reverse is true and he finds his London balance lagging behind the market for his sterling drafts in New York, he will be eager to increase the balance by buying bills and slow to deplete it still further by selling his own drafts. It is customary to say that the rate of exchange in the New York market from day to day is regulated by the supply and demand of bills of exchange. This is true; for it is the supply of sterling bills offered for sale to New York bankers which creates the London credit, and it is the demand for bankers' drafts which determines the profitable employment of the credit; hence the relation of supply to demand is the deciding factor in the banker's evaluation of a given foreign bill of exchange.

If the exporters of goods to England could offer sterling bills on the New York market in amounts substantially equal from day to day to the demand of the importers for bankers' sterling drafts, London credits could be utilized as rapidly as they accrued, and so would never grow unduly large or unduly small. But no such equation of supply to demand can be maintained over long periods of time, for each is subject to seasonal fluctuations peculiar to itself. The supply of sterling bills arises in greatest volume during the late fall and early

winter when our exports of foodstuffs and raw materials are heaviest; while the demand for bankers' drafts — these being used to effect payments due in widely separated markets for importations of various goods and services — does not coincide with variations in the supply of commercial bills. There are periods of the year, therefore, when the New York bankers are building up large balances in London against which they have relatively few opportunities to draw, and other periods when these balances are being drawn down more rapidly than the bankers can repair them through the purchase and remittance of sterling bills. Under the former of these conditions, the bankers will be more eager to sell than to buy and the rate of exchange will, consequently, fall below par; under the latter, they will be more eager to buy than to sell and the rate will rise above par.

The practice of the exchange market has resulted in the adoption of a definite scale of steps or gradations in which quotations above or below par are expressed. For years the bankers in New York raised and lowered the prices asked for their sterling demand drafts in gradations of $\frac{1}{8}$ cent per pound. Thus, starting, let us say, from 4.86, the rates would be raised through the series: 4.86 $\frac{1}{8}$; 4.86 $\frac{1}{4}$; 4.86 $\frac{3}{8}$, etc.; and lowered through the series: 4.85 $\frac{7}{8}$, 4.85 $\frac{3}{4}$, 4.85 $\frac{5}{8}$, etc. At the present time, however, a departure from this method of quoting sterling is making its appearance in certain financial journals. The scale employed is expressed in decimal form and rises and falls by gradations of \$.005 per pound. For example, beginning at par, 4.8665, quotations rise in the decimal quotation through the series: 4.8670, 4.8675, 4.8680, etc.; and fall through the series: 4.8660, 4.8655, 4.8650, etc. This change in the method of quoting sterling exchange amounts, of course, to splitting the former scale into finer gradations, thus making possible a nicer adjustment of bid to offer under competition. For this reason, and because it is somewhat less cumbersome than the older fractional quotation, the more recent practice seems preferable. The older form, however, still survives in the market.

In a similar manner, custom has prescribed a more or less

rigid system of quotations for other bills than sterling. In franc exchange, the case is somewhat complicated by the fact that par, itself, is expressed in two different ways: either in francs per dollar (par is: 5.1826 francs equal one dollar) or in cents per franc (par is: 19.3¢ equal one franc). When par is expressed in the latter form, the rate rises and falls in gradations on 1/10¢ per franc; when the former, and older method, of quoting par is employed, it is the custom to vary the quotations by intervals of 5/8 centime each. Thus, starting at 5.18, the rates rise through the series: 5.17 1/2, 5.16 7/8, 5.16 1/4, etc.; and fall through the series: 5.18 3/4, 5.19 3/8, 5.20, etc. It should be repeated, perhaps, that in this case the higher figure means the lower rate and *vice versa*. A change in the quotation from 5.17 1/2 to 5.18 3/4, for example, indicates that each dollar will buy .01 1/4 more francs than formerly, or that franc bills have become cheaper, while a reverse change of equal amount means that franc bills have grown correspondingly dearer.

As in sterling exchange, there has been an attempt to resolve franc quotations into a series of finer gradation, but the method employed is somewhat cumbersome and confusing. The old scale with its variations of 5/8 centime is retained, and a dealer wishing to quote a rate between any two steps in the scale does so by offering a rebate or charging a premium of a fraction of one per cent on the face of the bill. Quotations such as the following are sometimes to be seen: 5.18 3/4 *plus* 1/32; 5.18 3/4 *minus* 1/16. The former of these quotations represents a banker's offer to sell a demand draft at the rate 5.18 3/4 francs per dollar, with an additional charge of 1/32 per cent upon the sum total of the bill. Such a draft for 51,875 francs would cost \$10,000 ($51,875 \div 5.1875$) *plus* 1/32 per cent of \$10,000, or a total of \$10,003.12. At the second rate, the same bill would cost \$10,000 *minus* 1/16 per cent of \$10,000, or \$9993.75. Conventions similar to these control the quotations on bills drawn in other moneys. German and Dutch exchange are quoted in gradations of 1/8¢ per mark or guilder, sometimes with additional charges or rebates as in the case of franc bills. Exchange on Switzer-

land, Italy, Belgium, and Greece is quoted in like manner with exchange on France.

17. **The specie points.** The exchange rates cannot rise or fall indefinitely. Except when conditions of the exchange market are abnormal, a somewhat rigid limit is imposed beyond which the discount or premium cannot go, and this limit has the effect of confining the fluctuations of the rates within a rather narrow range. The point at which the rise or fall of the exchange rates will stop is determined by the cost of shipping specie from one market to the other. On sterling exchange, for example, the premium per pound cannot be more than the cost of shipping from New York to London enough gold to make a pound; nor can the discount exceed the cost of bringing from London to New York the gold content of one pound. Because of their relation to the cost of transporting gold, the maximum and minimum quotations are called the *specie exporting* and the *specie importing points* respectively.

The movement of gold in or out of the country is effective in stopping the decline or the rise of the rates of exchange because it removes the cause of the decline or the rise. As we have seen, the force which drives the sterling rate below par is an excess supply of sterling bills, whose immediate effect is to cause the London balances of New York banks to grow disproportionately large. A continuation of this condition will force New York bankers, who have transferred large amounts of their available funds to London through the purchase of commercial bills, to instruct their English correspondents to remit a part of these funds in bullion. But the shipment of gold is an expensive operation, and to avoid it the bankers will endeavor to sell every possible sterling draft against their London credits; for by so doing, they will realize upon these credits in dollars and cents without the expense of importing gold. If lowering the rate of exchange will avail to sell more drafts, the rate will be lowered, but not indefinitely; for a point will be reached beyond which the loss in discount will be greater than the expense per pound of importing specie (the bankers' alterna-

tive method of realizing upon their London credits), and to push the rate lower would be to adopt the more expensive means of transferring London balances to the vaults of the New York banks. When, therefore, the sterling rate has fallen to the point at which the seller is losing as much from the face of his bill as he would lose by paying the cost of transporting the gold in which it will be cashed in London, the supply of bankers' bills will disappear from the market. Foreign correspondents who hold the bankers' balances will be instructed to ship the amount due in the form of gold bullion. On the other hand, at this point, or very slightly below it, the bankers will *buy* an unlimited amount of sterling commercial bills, regardless of the condition of their London balances; for at rates so low, the buyers can afford to collect the proceeds of the bills in specie, box, insure, and ship the gold to New York and still make a profit from the transaction. This, then, is the specie importing point; under normal conditions, the fact that sterling, or other foreign, rates are standing at this point is sufficient proof that New York is drawing gold from the foreign center in question. Reviewing what has been said in this paragraph, it should be clear that the decline in the rate is stopped at the specie importing point by the removal of its cause: that is, by wiping out the supply of, and increasing the demand for, sterling bills.

By a similar force, the rise of the rates of exchange is stopped at the specie exporting point. A premium appears when the demand for bankers' bills is excessive in comparison with the supply of commercial bills with which to strengthen the foreign balances; for under this condition, the credits of the New York bankers in foreign money centers will approach exhaustion, and the power to draw more demand drafts will be sharply curtailed. If the demand continues unchecked, the competing buyers of bankers' bills will bid up the rate until the cost in premium is as great as the cost of exporting gold to the foreign center. At a rate slightly above this point, an unlimited supply of bankers' bills will appear on the market; for with so great a premium, the bankers can afford to ship

to London and other cities gold enough to redeem every bill they draw, paying all the costs of the transaction, and yet make a profit. The buyers of bankers' bills, on the other hand, have always open to them the alternative of making their remittances in specie, and they will begin to avail themselves of this alternative if the premium on the bills much exceeds the cost of shipping the gold. Thus the limit to the premium on foreign bills of exchange is fixed at the specie exporting point.

18. Determination of the specie points. The specie points are not absolutely rigid, varying in harmony with variations in the different items which make up the cost of shipping specie. No form of money possesses international purchasing power except gold; and in international trade, gold money is taken by weight and not by tale or count. The shipment may be made in the form of gold coin or of gold bars with slightly different costs in each instance. To illustrate the method of computing the specie export point in sterling exchange, let us take a standard transaction involving the shipment of \$100,000 in United States gold coin from New York to London.

COST OF SHIPPING \$100,000 IN U.S. GOLD COIN, NEW YORK TO LONDON

Cooperage, two casks @ \$3.50.....	\$ 7.00
Cartage.....	8.00
Freight, 1½ per cent of value.....	150.00
Interest, three days @ 6 per cent.....	50.00
Insurance, @ 50¢ per thousand.....	50.00
Total shipping costs.....	<u>\$265.00</u>

This gold may be obtained by presenting at the Subtreasury in New York \$100,000 in gold certificates; their value must be added.

Shipping costs, as above.....	\$ 265.00
Value of coin in New York.....	100,000.00
Total cost of the shipment.....	<u>\$100,265.00</u>

It is assumed that the shipping costs in the above computation are self-explanatory with the exception of the interest

item. This, it will be noted, is computed for three days, which, obviously, is not the length of time consumed in the passage of the steamer across the Atlantic. However, the banker's loss of interest is not governed by the steamer's passage, but by the interval of time which elapses between his withdrawal of \$100,000 in gold certificates from his vaults and the recovery of these funds through the sale of a demand draft against the shipment. It is even possible for the banker to avoid loss of interest entirely by selling his demand draft at the time he withdraws the gold from the Sub-treasury. If the draft and the gold go forward by the same steamer, the gold will arrive in London in time to redeem the draft. But complete avoidance of interest cost is not often possible. If the steamer sails in the forenoon, the gold must be put aboard the day before; the purchaser of the demand draft will have made his arrangements with the banker some time in advance, agreeing to pay by check on the day of sailing; the check may have to be sent through the Clearing House on the day following before the banker's cash reserve is increased by the sale of the draft. Interest will, consequently, be lost from the moment the gold certificates are withdrawn on the day preceding the sailing until the proceeds of the check return from the Clearing House on the day following the sailing. In actual practice, this interval of time varies considerably as between different transactions; the maximum is rarely more than three days, and the minimum may be anything less than this, or nothing at all. The New York rate of interest is used in computing the loss of interest, since it is here the banker's funds would have been employed if they had not been expended in the purchase of gold.

Returning, now, to our task of determining the specie point, we may proceed from the fact that it has cost the New York banker \$100,265 to place ten thousand gold eagles in London. The banker's drafts against this gold will be drawn in pounds sterling, and the total amount that he can draw will depend upon how much credit, stated in pounds, this shipment will give him in London. The Bank of England is ready at all times to buy gold coin of the fineness of the

United States eagle (9/10 fine) at the price which hovers about 76s. 4d. per ounce. Ten thousand new gold eagles contain 2,580,000 grains of gold, nine tenths fine; but these coins will not have been entirely full weight at the time they were obtained from the Subtreasury, and, furthermore, abrasion in transit will have still further reduced their weight before they are offered to the Bank of England. For these reasons, we may allow a loss of 1/10 per cent, or 2580 grains; our computation, then, takes the following form:

STERLING CREDIT CREATED BY SHIPPING 10,000 GOLD EAGLES, NEW YORK TO LONDON

10,000 gold eagles, full weight.....	2,580,000 grains, 9/10 fine
Subtract loss in weight, 1/10 per cent..	2,580 grains
Weight of gold offered to Bank of Eng- land.....	<u>2,577,420 grains, 9/10 fine</u>

2,577,420 grains is 5369.62 ounces

Bank's price is 76s. 4d. per ounce

5369.62 ounces @ 76/4 equals £20,494.05

Total sterling credit in London..... £20,494 1s.

By shipping ten thousand gold eagles to London and selling them to the Bank of England, the banker in New York has gained the power to draw sterling demand drafts totaling £20,494 1s. The total cost of this credit was \$100,265; hence it has cost per pound, \$4.8918. This is the specie exporting point on sterling exchange; by selling his drafts at this rate, the banker will receive exactly what it costs him to create the credit, including in the cost the value of the gold he has shipped. If the rate rises even slightly above this point, an unlimited supply of sterling demand drafts will appear on the market; each may be covered in gold by the drawing banker, yet the transaction will return him a profit. The specie exporting point and the upper limit to the sterling rates will hover about 4.8918 so long as the shipping costs remain unchanged.

The costs of importing specie are fixed by the same principles as those just discussed, but with some slight variation

in the individual items. Normally, English gold sovereigns or gold bars of a certified fineness may be bought from the Bank of England at fixed rates; and it is usually possible, also, to buy United States gold eagles which have been stored there as the result of gold shipments from this side. In any case, the gold must be bought by weight. If bars or English coins are imported, these must be sold by weight to the assay office in New York, and the importer must bear all loss through abrasion. If the shipment is composed of United States coin, the money may, of course, be added directly to the cash reserves of the importing bank and loss through abrasion may be avoided. Most of the shipping costs — for instance, insurance, cartage, freight, cooperage — are practically identical for movements of gold in both directions. But there is a striking difference in the interest item: the maximum loss is about twenty days when gold is imported by New York bankers from London, and not more than three days when gold is exported to London. In each case, the loss is measured by the interval of time which must elapse between the withdrawal of funds from the banker's vaults in preparation of the gold shipment, and the return of these funds as a consequence of the gold shipment. When exporting gold, the outgo and income to the banker may occur almost simultaneously, since the sale of the demand draft which covers the gold shipment follows closely upon the withdrawal of the gold, itself.

However, when gold is imported the banker is deprived of the use of his money for a longer period. He must first obtain the specie from the Bank of England, and this he does by sending over a credit instrument payable in gold. This instrument is usually a sterling demand draft; the importing banker buys it in New York, and sends it to London to be cashed in gold or in Bank of England notes which are redeemable in gold. The gold is shipped and the banker must await the arrival of the steamer which brings it. The outgo of funds occurs when the draft is bought; the income, not until the shipment has arrived and has been turned into United States money. Thus interest is lost during the time con-

sumed in both voyages to and from London plus whatever interval elapses between the arrival of the steamer which carries the demand draft to London and the departure of the steamer which brings the gold. This period of time may be reduced by about ten days if a sterling cable is used in place of a sterling demand draft for the purpose of obtaining gold in London.

In illustration of these principles, let us assume that a banker in New York imports the ten thousand gold eagles which figured in our previous illustration, obtaining them from the Bank of England at the selling price of 76*s.* 7*d.* per ounce and using a demand draft for this purpose. These gold pieces were assumed to be 1/10 per cent light in weight, which brought their total weight down to 5369.62 ounces. Under these conditions the calculation of the specie importing point proceeds as follows:

COST OF 10,000 GOLD EAGLES AT BANK OF ENGLAND'S SELLING PRICE

5369.62 ounces standard gold @ 76/7 per ounce £20561.17

The eagles will, of course, be worth \$100,000 upon arrival; let us assume the same shipping costs as before with the exception of the interest loss, which we will assume to be twenty days at 5 per cent.

NET RECEIPTS FROM IMPORTING 10,000 GOLD EAGLES, LONDON TO NEW YORK

Value of the gold upon arrival	\$100,000
Subtract shipping costs:	
Cooperage, cartage, freight, insurance	\$265
Interest at 5 per cent for 20 days . . .	274
Total	539
Net receipts of importation	\$99,461

At the cost of £20,561.17 the banker has obtained \$99,461; this gives a rate per pound of \$4.8373 ($99,461 \div 20,561.17$). Under the conditions assumed, therefore, the specie importing point in New York is 4.8373.

In practice, the correspondent banks in New York and London which engage in the business of shipping gold arrange between themselves to carry through the transaction upon the cheapest possible terms, and, among other things, to reduce the interest cost as much as possible, by using the most economical means of obtaining the gold. International shipment of gold is a business handled almost entirely by a few specialists, a small number of the larger finance houses with international connections and with all facilities for reducing the cost of the business. It is conducted, as is every other commercial transaction, solely for a profit. Those who engage in the business are governed by the circumstances of the moment, computing the costs according to the rates of freight, insurance, interest, and the price of gold which obtain at the time, and from these costs computing the quotation on their demand drafts which will return them a profit when the draft must be covered with specie. Since each of these costs is somewhat variable, the specie points show a certain amount of elasticity; they are, nevertheless, effective in limiting the fluctuations of the rates of exchange, at any given time, by removing the cause of a premium or a discount.

The specie points on franc, mark, yen, and other bills drawn on gold standard countries are determined by the principles which have been discussed with reference to sterling exchange. There are obvious variations in the items embraced in the calculation due to differences in the shipping and interest costs between New York and these different foreign centers. Less obvious variations arise from differences in the terms upon which gold can be bought and sold in the markets abroad. The central banks of these markets offer buying and selling prices for bar gold and foreign gold coin which are subject to some slight variation from time to time within each market, and which differ as between markets as the coinage laws of the countries differ. But it is not essential to our purpose to enter into this technical detail; in each case, governed by the conditions of the time and place, the specie points on the exchange rates between gold standard countries are determined by the costs of shipping

gold between the points involved in the rate. In precisely the same manner, the specie points on exchange between two silver standard countries are determined.

19. **The gold exchange standard.** The subject of the gold exchange standard has been reserved for discussion at this point, although it is here somewhat out of its logical position. This standard has been adopted by certain countries, formerly on the silver standard of coinage, which have desired to stabilize the exchange relations between their silver coins and the gold coins of other nations by utilizing the market for foreign bills of exchange. Adequate explanation of this standard presupposes a knowledge of the principles underlying the specie points.

As explained on another page in this chapter, there can be no fixed par of exchange between a silver and a gold standard country so long as the standard coins of each are influenced by the fluctuating values of the two metals of which they are composed. Since each metal fluctuates in value independently of the other, fixed quantities of the two metals (represented by the standard coins of the two countries) cannot long remain equal in value. Such unstable pars of exchange cause abrupt and non-predictable changes in the market rates of exchange quoted in gold standard countries on bills drawn in silver, and *vice versa*, which increase the difficulties of carrying on commercial and financial transactions between the two markets. These uncertainties and the depressing influence which they exert upon international commerce, provide the motive which has induced silver standard countries to adopt the gold exchange standard.

The first step in the direction of giving a silver coin a stable exchange value in terms of gold is to break the connection between the value of the silver coin and the value of the metal of which it is composed. The reason why any standard coin rises and falls in value in close harmony with fluctuations in the value of its metal content — why, for example, the value of the gold dollar moves in harmony with that of gold bullion, and the value of the silver tael in harmony with that of silver bullion — is because the mints are open to free

coinage. When a metal may be coined in unlimited amounts upon fixed terms and the coins may be reduced to metal at any time by the process of melting, the free movement of metal into coins and coins into metal prevents any great difference between the value of the coin and that of the specific amount of metal which it contains. If 23.22 grains of pure gold become worth more in the form of a dollar than they are worth in the form of raw gold, a stream of gold will flow to the mints until the difference is wiped out; conversely, if this amount of gold becomes worth more in the form of bullion than in the form of a dollar, dollars will be melted and sold in the bullion market. The same forces of supply and demand operating in the silver standard countries bring about a fixed relationship between the values of the standard coin and the standard metal so long as the mints are open to free coinage. When, however, the mints are closed to the free coinage of silver, and the number of silver coins permitted in circulation is, by consequence, strictly limited, the value of the standard coin will no longer be subject to fluctuations in harmony with the value of the metal, and the attempt to give this standard coin a fixed par of exchange with gold may hope of success.

After the mints have been closed in the silver country, the price of silver may fall in the market without depressing the value of the standard coin. Coins will no longer represent merely specific amounts of metal; they will have a scarcity value due to the strict limitation on their manufacture and the need of the people for a sufficient quantity of money to function as a medium of exchange. If the trend of the price of silver is upward, however, a point may be reached at which it becomes profitable to melt the coins and sell them as bullion; but this event can be forestalled by the Government by lightening the weight of the silver coins as occasion may arise. It is also the practice to guard against this contingency by overvaluing the silver coin at the outset — that is, by so limiting the amount in circulation as to give the coin an initial value in excess of its metal content. Having adopted these measures, the Government proceeds to place

a definite gold price upon the silver money by undertaking to exchange this money for gold at the treasury upon stated terms.

At this point it may be said that a fixed par of exchange has been created between the standard silver coin and the gold money of other nations. But something must yet be done to prevent the market rates of exchange from deviating too widely from this par. Between two gold standard or two silver standard countries, as we have seen, this restraining influence upon the rates of exchange is exerted by the shipment of specie whose effect is to set rather rigid minima and maxima to the range of fluctuation of the market rates of exchange. But when, by the methods just described, a silver country has given its standard coin an artificial value divorced from the value of its metal content, the specie points will function in one direction only; in the silver country the rates of exchange on bills drawn in gold will have a specie importing point, but no specie exporting point, while in gold countries the rates on bills drawn in the silver money will have a specie exporting, but no specie importing point. Hence, the gold rates in the silver country, although they cannot fall below a certain point, may rise indefinitely; and, conversely, the silver rates in the gold country, although they cannot rise above a certain point, may fall indefinitely. This is true because specie will move in one direction only between the two countries, namely, from the gold country to the silver; the silver coins, having an artificial value, are not exportable, whereas the offer of the Government of the silver country to exchange these coins for gold upon fixed terms gives the gold coins of other countries an export value.

The final step in the process of stabilizing the terms of exchange between the silver coin and the gold coin of other countries is to supply this lack of a specie exporting point in the silver country. This the Government does by undertaking to sell an unlimited amount of exchange payable in some gold standard country at fixed rates which stand as nearly as possible at the exporting point; while, at the same time, an agent of the Government in the gold country offers

bills payable in the silver coin at rates approximating the specie exporting point there. Business men in the two markets will, of course, not avail themselves of these offers of exchange so long as they can buy the bills they need at cheaper rates; but when the rates rise to the specie points in these respective markets, the Government bills will be bought and a further rise of the rates prevented. It is not the practice to stabilize the rates with respect to more than one gold standard country, but this is sufficient to give the silver money a stable value in terms of other gold coins, as well; for, as we have seen, the standard gold coins of all nations have fixed pars of exchange with each other, and any silver coin exchanging on fixed terms with one of them will have a fixed par with the others. In summary of the preceding explanation we may say that the gold exchange standard has these essentials: (a) there must be no free coinage of the standard silver coin; (b) this silver coin must be given a fixed value in gold; (c) the exchange rates between the silver country and gold countries must be confined within the specie points by reason of the Government's offer to supply gold bills of exchange in the silver country at certain maximum rates, and silver bills of exchange in the gold country at certain maximum rates.

Illustration of these principles may be taken from the experience of the Philippine Islands. In 1903, the mints were closed to the coinage of the silver peso and this coin was given an inflated value of fifty cents in gold. The Insular Treasury then undertook to sell for pesos drafts payable in gold in New York from a special fund provided in that city for the purpose. The rates charged for these bills were fixed at a premium of 1 per cent for demand drafts and $1\frac{1}{8}$ per cent for cables, these rates being set as nearly as possible at the specie exporting point on dollar exchange in Manila. In like manner, the Custodian of the Gold Standard Fund in New York offered for sale drafts payable in pesos in Manila, charging a premium of $\frac{3}{4}$ per cent for cables and $\frac{3}{8}$ per cent for demand drafts; these rates were also fixed approximately at the specie exporting point in New York on Manila exchange.

The money received in Manila in exchange for New York drafts is withdrawn from circulation, to be paid out only in redemption of Manila drafts sold by the Custodian of the Fund in New York. Thus, when exchange on New York had risen to the specie exporting point in the Philippines, the Treasury supplied the Philippine merchant with gold in New York by selling him a draft payable in dollars, and withdrew from circulation in the Islands an equivalent amount of specie. When, in New York, the exchange rates on Manila rose to the currency exporting point (United States paper notes have currency in the Philippine Islands), the agent of the Philippine Government supplied drafts payable in pesos in exchange for dollars. These drafts, when encashed in Manila, place a corresponding amount of money in circulation there.

By somewhat similar methods, the Indian Government stabilized the rates of exchange between the rupee and the pound sterling. In 1893, the mints were closed to the free coinage of the rupee and the value of the rupee was raised by the Indian Government to 16*d.* or Rs. 15 to the pound, provision being made for the issue of silver rupees at this rate in exchange for gold. In London, the Bank of England offered, weekly, a certain amount of bills payable in Calcutta, Bombay, and Madras in rupees, which were sold to the highest bidder; the rate bid for these drafts did not, of course, rise above the specie exporting point, since British merchants had the option of shipping gold to India and exchanging it for the rupee at the rate of Rs.15 to the pound sterling. In normal times the demand in India for sterling drafts rarely exceeded the supply sufficiently to drive the sterling rates to the export point, but on two occasions when this occurred, the Indian Government came into the market as seller of sterling bills at a rate approximating the specie exporting, thus stopping the rise of the rates.

The gold exchange standard has also been introduced into the Straits Settlements. The silver dollar in circulation there was given a value of 28*d.* in gold; the Singapore Government undertook to sell cable transfers on London at the rate of

27 11/16*d.* per dollar (a premium of 5/16*d.*, which was approximately the specie exporting point on sterling exchange in Singapore); while London sold cable exchange on Singapore at 28 3/16*d.* (a premium of 3/16*d.*, again approximately the specie point). Many years of successful operation of the gold exchange standard in these countries has demonstrated its effectiveness in giving silver coins a fixed par with gold coins and confining the fluctuations of the rates within the limits of the specie points.¹

20. **Causes of abnormal fluctuations in the rates of exchange.** Under certain abnormal conditions, the rates of exchange will break through the specie points and stand for short periods of time at excessive discounts or premiums. One of the most powerful of causes producing such a situation is a crisis in the political or economic affairs of the nations concerned. If, for example, there were rumors in New York of an impending financial panic in London, every banker or merchant in New York who had payments due him from England would be in an inordinate hurry to turn his credit into dollars. Thus a sudden supply of sterling bills would be thrown on the market and the exchange rates would break. The discount might not stop at the specie import point, since fear that gold would be unobtainable in London might restrain the bankers from buying sterling drafts even at rates low enough to cover the costs of importing specie. Moreover, even if the bankers were confident of their ability to turn every draft into gold in London, the flood of bills, and the insistence of the sellers upon immediate payment, might be so great as to deny the bankers sufficient time to bring the gold to New York in large enough quantity to keep themselves in funds for the purchase of bills.

Under panic conditions, time becomes a vital factor, and, despite the marvelous perfection of the mechanism for mak-

¹ The breakdown of the gold exchange standard in all the countries mentioned under the stress of the widely fluctuating prices of silver during the war had not been repaired at the time of writing. It is probable that the standard will be retained when conditions are again normal, though the evaluation of the different silver coins in terms of gold may be adjusted to changed conditions.

ing payments between nations, the shipment of gold is still a time-consuming process. When business confidence is breaking down, even the few days which must elapse between the purchase of sterling bills in New York and the receipt of gold from London may be sufficient to keep the demand of the bankers lagging behind the supply of bills. Furthermore, in times of crisis, the risk involved in the purchase of foreign bills of exchange is abnormally large; the foreign drawee may refuse to accept the draft, or may be insolvent when it matures. This uncertainty as to the security of the bills of exchange still further retards the demand of bankers during periods of crisis.

For these reasons, the exchange rates are a sensitive barometer of the state of international business confidence. The rates which rule the market result from the reflection of the keenest and best-informed minds in the business world upon the economic condition of all the nations. So exactly do these rates record the favorable and unfavorable elements in the economic life of any country that the trained observer can, from their course, interpret with considerable accuracy the economic health of the market on which they are drawn. There is no better indication that the business structure of a nation is considered unstable than the appearance of abnormal discounts against her in the exchange markets of other nations. Each crisis and financial panic through which the United States has passed in recent decades has seen American exchange quoted at excessive discounts in London and other financial centers.

Of similar effect upon the rates of exchange is the danger of war, revolution, or other political disturbance. Such crises in the political life of nations work havoc among the business men, undermining credit and often causing wholesale insolvency. Forecasting an event of such magnitude, the traders in the exchange drawn upon the nation affected will react in the same manner as if this nation were threatened with commercial crisis; every one will be reluctant to pay out money to acquire credit instruments drawn upon banks or business men in the troubled area, while those who have such instru-

ments for sale will be anxious to turn them into cash. Since no one can be assured that the political upheaval will not prevent the withdrawal of gold from the foreign market, the specie importing point will temporarily be ineffective in arresting the decline of the exchanges. For these reasons, the varying fortunes of a nation at war will be registered in the rates at which her bills are quoted in the markets of other nations; alternating victory and defeat will quickly be reflected by the rise and fall of these rates.

Of course, the specie points cease to limit the rise or fall of the exchange rates when restriction or prohibition is placed upon the movement of gold between nations. If the restriction take the form of a tax or a premium charged upon the gold when it is obtained for exportation, the effect will be simply to establish a new specie point which includes the new cost, and this new point will be as effective as the old one so long as the conditions remain unchanged. For example, if a tax of ten per cent must be paid to obtain gold in London, this new charge will be added to the other costs of importing specie and the effect will be to remove the specie importing point to a lower quotation and so permit a greater discount on sterling bills. It must not be assumed, however, that the tax on gold will of itself produce a discount on sterling exchange in the markets of other countries. If a discount appears, it will be because the supply of sterling bills overbalances the demand for them, and the influence of the tax on gold will be confined to permitting any discount which does appear to reach a lower point before it is checked by the importation of specie.

When nations prohibit the exportation of gold, or refuse to surrender it in exchange for checks or paper money at the central banks, the specie importing point will no longer affect the rates at which bills drawn on such nations are sold in foreign markets. Since the Great War, the belligerent nations of Europe have been so drained of gold that no more is obtainable at their central banks, and the supply in the market is so meager that it is impossible to foretell from day to day what premium gold will command in terms of the paper money of

these nations. The best view to take of the exchanges under these conditions is that the nations in question are no longer gold standard nations and that the pars of exchange must be calculated anew by one of the two methods discussed earlier in this chapter. While the old gold pars of exchange are in abeyance, the specie importing and exporting points have, of course, no corrective influence upon the fluctuations of the rates; or, to state the matter with greater accuracy, the old specie points have lost their significance and new ones must be derived to conform to the new pars of exchange based on the premium on gold in the paper standard countries. A striking illustration of the effect of a removal of the specie points upon the rates of exchange is to be found in the quotations on bills drawn upon Buenos Aires during the month of July, 1920. The supply of Argentine bills in the New York market began to outstrip the demand of our importers and, consequently, the quotations moved to a discount. This discount was temporarily stopped at the specie point as gold began to move into New York, until the Argentine Government forbade further exportation of gold, when the lower limit was suddenly removed and the quotation fell to an abnormally low point.

21. Relation of the exchange bankers to the rates of exchange. It is commonly believed that the dealers in the exchange market fix the rates at which the different bills are bought and sold. Our discussion, however, has shown that what these dealers do in reality is to offer to buy or sell bills of exchange at rates which reflect the desirability to them of funds in the foreign cities where the bills are payable. The desirability of these funds, it may be repeated, is a function of their amount in relation to the use which can be made of them; their amount is determined by the supply of bills offered to the dealers by their clients in the business world, and their use, by the demand of other business men for the drafts which the dealers are able to draw against the foreign funds. Thus the rates are controlled fundamentally by the forces of demand and supply of bills of exchange, fluctuating under normal conditions within the narrow range fixed above

and below par by the costs of exporting and importing specie. Of these forces of demand and supply, some operate with relative constancy and uniformity, and are, therefore, susceptible of prediction; while others vary abruptly and cause sudden fluctuations in the rates of exchange. It is, for example, possible to foretell with some degree of accuracy not only what amount of bills will be drawn against our shipments of cotton, but also at what season of the year these bills may be expected to appear on the market. So also with the seasonal demand for exchange with which to cover the expenditures of American tourists in Europe, and other particular sources of demand which go to make up the total demand of the New York market. Underlying all other forces and dominating the rates of exchange over long-run periods, is the foreign trade of the nation; about these basic causes play the more occasional and erratic forces which produce a supply of bills or cause a demand for them, and so cause the daily fluctuations of the rates which depart from the expected trend.

It is the business of the exchange dealer so to multiply and perfect his means of gathering information regarding the sources of supply and demand as to be able to predict what the behavior of the rates will be. Only slightly and temporarily, by processes which we shall examine in the following chapter, can the dealers in exchange influence the rates, and then chiefly by coöperating with the forces of demand and supply which are their final causes. In the main, all they can do is to determine with all possible exactness what quotations will result from the interplay of the forces which arise from the business world about them, and govern their own terms of purchase and sale accordingly. Thus, with sterling rates at par, if the bankers have reason to expect the forthcoming supply of sterling bills to be so large as unduly to expand their London balances, they will set the rate on their demand drafts somewhat below par. If their prediction proves to be wrong, the unexpected demand will soon cause them to raise their rates until a point is reached at which equilibrium results between their purchases and sales; that

is to say, a point at which they are able to replenish their London balances by the purchase of sterling bills, and reduce them by the sale of demand drafts in substantially equal amounts. These tentative bids and offers of the exchange bankers are approximations to the ideal rates at which demand and supply will be in equilibrium.

CHAPTER IV

INTERRELATIONS OF THE RATES OF EXCHANGE

22. The schedule of rates in the same market. Bills of exchange are instruments and aids of commerce, drawn not to conform to a set pattern, but to meet the needs of commercial transactions, and deriving their character in each particular instance from the terms of the transaction out of which they arise. When brought into the exchange market for sale, they disclose both similarities and differences; similarities due to certain basic likenesses which characterize all international trading; differences due to the diverse character of their parties and of the terms of the transaction which have resulted from bargain between them. The practice of the exchange market in quoting rates upon these different classes of bills takes account of both the uniformities and the differences; a few main groups are made, each of which commands a specific rate of exchange, a rate which may be called the normal buying price for bills within that group. Account is then taken of the individual differences between the bills of exchange thus classified together, and the normal rate is adjusted by bargain between the banker and his client when the negotiation of the bill is consummated. The normal rates, therefore, form a series or schedule which lays down the general terms upon which the dealers in the market are prepared to buy certain kinds of bills; the rates which compose this series are the following:

- (1) The rate for telegraphic transfers or cables.
- (2) The rate for bankers' demand drafts or checks; called the "sight" rate.
- (3) The rate for bankers' long bills (sixty or ninety days).
- (4) The rate for commercial long bills.

The basis of the schedule in any market is the rate for

bankers' demand drafts,¹ or the *sight* rate, as it is called, for upon this rate, by processes discussed in the preceding chapter, are focused the forces of supply and demand in the market at large. The other quotations in the schedule are derived from this standard rate and connected with it in more or less rigid union, the "spread" between the sight rate and the rates for other classes of bills being determined by the differences in security and term of life which distinguish these bills from bankers' demand drafts.

23. The cable rate. Cables, alone, command a rate of exchange higher than the sight rate. Drawn by bankers upon foreign banks, cables are identical in security with bankers' demand drafts, differing from the latter only in the time element involved in their use. To make clear why this difference causes a *spread* between the rates for checks and cables, it is necessary first to explain how the time element in bills of exchange affects the costs of bankers who sell them; for only when the time element is drawn into the banker's calculations as one of the costs involved in the sale of a bill of exchange does it influence the rates of the exchange market. If, in order to place himself in position to sell a particular kind of exchange, the banker must first make an advance of funds over a certain number of days, his loss of interest must be reckoned among the costs of supplying the bill. Drafts sold by bankers in the market are drawn against foreign balances placed to the bankers' credit in the cities where the drafts are payable. When, to place these balances in the foreign city in time for the redemption of the draft, it is necessary to expend money some days in advance of drawing, interest will be lost during the interval of time between the banker's expenditure and the return of his funds through the sale of the draft. In order to assure himself a profit from

¹ The rate for bankers' bills is not always uniform, since there are slight differences in the credit rating of different bankers. The basic rate of the market is the rate for the sight drafts of *prime* bankers; that is, bankers of the highest standing. The element of risk in these prime bills is near the vanishing point. The difference between the rates applying to the bills of different bankers is, therefore, almost negligible. These remarks apply, also, to the rates on bankers' long bills discussed below.

the sale, the rate at which the draft is priced must be high enough to return this interest along with the other costs. In the case of demand drafts, no interest cost need be included by the banker in his determination of the rate of exchange, since the cover for the draft may be bought upon the very day when the sale occurs. Both demand draft and cover will go forward by the same steamer, with the result that the foreign correspondent is placed in funds in time to redeem the banker's draft.

To illustrate this point, let us assume that a New York banker has sold a sterling demand draft for one thousand pounds drawn on a London correspondent. The buyer has procured this instrument to meet some particular need of his business, very probably the necessity of remitting payment to some English exporter. Six or seven days will pass before the demand draft will arrive in England; some hours, perhaps a whole day, in addition, before the payee will present it to the London correspondent for redemption. Clearly, if the New York banker buys a sterling bill which will be worth one thousand pounds sterling upon its arrival in England and sends it directly to the correspondent by the same steamer which carries his own sterling demand draft, the London banker will have funds in hand when presentment is made. On this side, the banker's purchase and sale may occur on the same day, so that no significant loss of interest need be involved in his purchase of cover for the draft upon his foreign balance. It is not the intention of this illustration to lay down the strict rule that exchange bankers go into the market and buy cover for each individual sight draft which they sell. None the less, this, in effect, is what they do; for the principle upon which they conduct their business in bills of exchange is one of compensating purchase and sale — the purchase of cover and the sale of drafts in substantially equal amounts from day to day — so that the two may offset each other without causing an interest loss. Hence, as a rule, the selling price for a demand draft does not include an interest charge; the banker's profit from this type of business is drawn, not from an advance of funds on his part, but from a slight difference

in his favor between the rates at which he buys cover and sells demand drafts.¹

When a cable is sold, however, a simultaneous purchase of cover is impossible. The telegraph will bring the draft to the correspondent within a few hours after its sale in New York and a credit must have been provided for it in London some time in advance. This means that sterling bills must have been bought at least six days before the cable is sold, and that the banker has lost interest through this period of time. The higher rate which cables command is to be attributed to this interest cost and not, as is sometimes assumed, to the extra cost of using the telegraph service; this extra cost is usually borne by the buyer of the cable as an additional and distinguishable charge, though when the amount sent is sufficiently large, the cable charge may be borne by the banker out of his profit in order to attract the business. The process of handling cables is somewhat different from that of other forms of exchange. The buyer does not receive an instrument from the banker to be remitted over the telegraph wire, but merely leaves the required sum at the bank, together with written instructions containing the name of the foreign payee. The banker then undertakes to wire in code to his correspondent an order that the latter pay a certain sum of money to the designated party out of funds which the banker has on deposit with him. The buyer may have informed his creditor in advance of the payment; or this detail may be left to the foreign correspondent.

Although it is correct to say that the cable rate is always higher than the sight rate, the exact difference between them does not seem always to depend upon precise calculation. If the banker's selling price for cables were governed strictly by the principles involved in the transaction, the spread between the cable and sight rate would be determined by the following computation: to the sight rate of the day when the cable is sold would be added interest upon the amount expended some days earlier for the bills which cover the cable

¹ For exceptions to this practice of compensating purchase and sale, see the footnote to page 19.

at the rate of interest which obtained when the cover was bought. In sterling exchange, cover for a cable sold to-day must have been bought at least six days ago; hence the cost of the cover cannot be computed from to-day's sight rate, but rather from the rate which ruled the market six days ago. The money thus spent to enable the banker to sell the cable could have been earning interest in the meantime; hence the total cost must include the loss of interest. In illustration of these principles, we may carry through a typical calculation by which the cable rate is determined. Suppose to-day's sight rate is 4.85; the sight rate six days ago, 4.84, and the rate of interest 4 per cent per annum. The calculation is, then, as follows:

To-day's sight rate.....	4.85
Sight rate six days ago, the cost of cover, 4.84.	
Interest at 4 per cent on 4.84 for six days.....	<u>.0032</u>
Cable rate.....	4.8532

Each pound sterling of the cable draft must bear an interest charge for six days at 4 per cent on the cost of its cover, 4.84; this amounts to .0032, which must be added to the present sight rate. In the exchange market no place is provided in the standard scale of rates for such a quotation as 4.8532 on sterling exchange; hence, under the assumed conditions, the cable rate would probably be set at the next higher standard quotation, 4.855.

Observation of the spread between the cable and the sight rates, appearing in market quotations, shows that the practice of the market is not governed by the fixed principles explained in the preceding paragraph. At times the bankers have large balances in foreign cities of which they are eager to avail themselves quickly; accordingly, they reduce the spread between the cable and the sight rates to stimulate their sales. At other times, the demand for cables is so large as to outstrip the cover provided by prior remittance of bills by the bankers, and then the cable rate soars high above the sight rate. The latter condition usually appears in times of

panic or financial uncertainty, when business men are insistent upon obtaining a form of remittance which will reduce the loss of time to a minimum, when the foreign beneficiary of the cable is willing to bear the extra charge in order to obtain his funds quickly; or when men with free funds desire to take advantage of a temporary situation in a foreign money center. The following series of quotations, taken from a New York financial journal for June 26, 1920, may serve to illustrate the normal spread between the cable and the sight rate:

DEMAND AND CABLE RATES, NEW YORK, JUNE 26, 1920

	<i>Demand rate</i>	<i>Cable rate</i>	<i>Spread</i>
London.....	3.96 $\frac{3}{4}$	3.97 $\frac{1}{2}$	$\frac{3}{4}$ ¢ per pound
Paris.....	12.04	12.02	2 centimes per \$
Switzerland.....	5.49	5.47	2 centimes per \$
Belgium.....	11.47	11.45	2 centimes per \$
Holland.....	35.625	35.75	12 $\frac{1}{2}$ ¢ per 100 guilders
Spain.....	16.68	16.75	7¢ per 100 pesetas
Argentina.....	41.50	41.70	20¢ per 100 pesos

24. The rate for bankers' long bills. The third rate in the schedule of the exchange market is that quoted upon bankers' long bills of sixty or ninety days' sight. These bills, drawn by bankers upon their foreign correspondents, bear as drawer and drawee names of the same credit rating as do demand drafts and cables, and so do not differ in security enough to affect to an appreciable extent the rates which they command. It is the time element, together with certain other costs involved in the transaction, which determines the spread between the rate for bankers' long bills and that for demand drafts.

The chief market for bankers' long bills is found among other bankers of the drawer's city who buy them as a complement of transactions in foreign exchange in which they are engaged. The intention of the buyer is to discount the long bill upon its arrival in the market upon which it is drawn, increase the total of his foreign credit by the amount of the discount, and by this means place himself in position to draw and

sell demand drafts in his own market. Sometimes the demand drafts have been sold already, and the long bill is bought as cover; but whether the transaction in demand drafts precedes or follows the purchase of the long bill, the significance of the long bill to the banker will be the same. Consequently, the price which he is willing to offer for it will be based upon two considerations: (a) the total amount of demand drafts which the possession of the long bill will enable him to draw; (b) the sight rate in the market at the time.

A banker's long bill will not create a foreign credit equal to its face. A reduction will be made on two counts; in the first place, the bill will be discounted in the foreign money market after acceptance; and, furthermore, the foreign correspondent will pay stamp taxes when negotiating the bill and will charge these back to the buying banker. The rate of discount which will be brought to bear upon the bill when sold in the money market can be determined by the buying banker from the published rates of which he will be informed daily by his foreign correspondents. The stamp taxes are fixed by the Government of the country upon which the bill is drawn, and these will be known to the banker. A subtraction of these two charges from the face of the long bill will inform him of the total amount in demand drafts which its possession will enable him to draw. The existing sight rate in his own market will set the price at which these demand drafts may be sold. With these facts before him, he is in position to compute his buying price. To illustrate this computation, let us assume that the banker's long bill is drawn for ten thousand pounds sterling; that the rate of discount on this class of bills in the London market is 3 per cent; that the stamp tax is $1/20$ per cent; and, finally, that the sight rate in the New York market on sterling bills is 4.85. The calculation falls into two parts:

LONDON CREDIT CREATED BY BANKER'S LONG BILL

Face of bill..... £10,000.

Minus charges:

Discount (63 days @ 3%) 51.78

Stamp tax ($1/20\% \times 10,000$) 5.

Total subtraction..... 56.78

Total sterling credit..... £9,943.22 (£9,943, 4s., 4d.)

VALUE OF LONDON CREDIT IN DOLLARS

(DETERMINED BY SIGHT RATE)

Amount of sterling credit.....	£ 9,943.22
Sight rate of day of purchase.....	4.85
Value of demand drafts drawn on London.....	\$48,224.61

Under the conditions assumed as to discount rate, stamp taxes, and sight rate, the purchase of a banker's sterling long bill for ten thousand pounds will create a credit which will sell for \$48,224.61; the value of each pound of the long bill will be $48,224.61 \div 10,000 = 4.8225$. This will be the rate of exchange offered by the buying banker.

Another method of arriving at this quotation is frequently employed by the bankers, as follows:

Sight rate of the day of purchase.....	\$4.85
Subtract charges per pound	
Discount ($63/365 \times .03 \times 4.85$)....	.0251
Stamp tax ($1/20$ per cent $\times 4.85$)..	.0024
Total subtraction.....	.0275
Buying rate.....	\$4.8225

This method arrives at the same conclusion, though it conceals somewhat the principles involved in the calculation.

25. **Rate of exchange for commercial bills.** There is no single rate in the exchange market applying to commercial bills of all kinds. Some types of commercial bills cannot be sold at all. They must be placed in the hands of the bankers for collection, the drawers waiting for the proceeds until payment has been made by the foreign drawee. At that time, dollar drafts may be bought in the foreign market for remittance to the drawer of the commercial bill, or the drawer's banker may leave the amount collected standing to his credit abroad and turn over its equivalent to the drawer at the sight rate of exchange. On other types of commercial bills, the bankers will advance a part of the face, holding the rest in reserve until collection is made and charging interest on the amount advanced. The credit element inherent in all bills of

exchange is most clearly evident in the case of commercial bills; bills drawn by bankers upon other bankers are often viewed as currency, rather than as credit documents, because of the implicit confidence of the business world in bank credit; but bills drawn by a merchant or other business man as a phase of a commercial transaction, when taken from the drawer in exchange for cash, carry a risk of loss which cannot be disregarded. When this risk is so great that the bankers refuse to buy the bill, but will take it only for collection at the drawer's risk, it cannot be said that the bill commands any definite rate of exchange; it is the custom of the exchange market to speak of these instruments as "collection bills."

To understand whether a particular type of commercial bill will be bought by the bankers, and what rate of exchange it will command if bought, it is necessary at this point to anticipate in summary form the description of the various kinds of commercial bills which will be given in later chapters. For our present purpose, it suffices to divide all commercial bills into two main types: the bill drawn by a business man upon another business man; and the bill drawn by a business man upon a banker who has agreed to act as acceptor on behalf of the second business man. To the first type, the name *trade acceptance* is given because of the mercantile nature of the acceptor's business; for a similar reason, the second type of commercial bill is given the name *bankers' acceptance*. We are dealing here solely with long bills; and in almost every case, whether they are trade acceptances or bankers' acceptances, commercial long bills are supported by collateral security in the form of documents — bill of lading, insurance policy, etc. — which give the owner of the bills control over the goods which have been sold. In the case of the first type of commercial bill — trade acceptances — these documents are surrendered to the drawee, either at the time of acceptance or when payment is made. With bankers' acceptances, the second type of commercial bill which we are now discussing, it is the universal practice of the exchange market to surrender the documents at the time of acceptance. These different characteristics of the commercial bill determine its

salability and its rate of exchange. We may summarize them in the following form:

(A) Trade acceptances, drawn by one business man upon another.

I: Documents against payment; called *payment bills*.

II: Documents against acceptance; called *acceptance bills*.

(B) Bankers' acceptances, drawn by a business man upon a bank.

I: Documents invariably against acceptance.

In the following discussion, we shall deal first with the second type of commercial bill — bankers' acceptances.

The *bankers' acceptance* can always be sold outright to exchange dealers. This type of commercial bill arises out of business transactions between business men of different countries whenever the buyer has secured the services of his banker as acceptor of the seller's draft, and has instructed the seller to draw against the banker for the value of the goods. The bill will be secured by the documents mentioned above, and these documents will be surrendered — thus leaving the bill free from collateral security — at the time of acceptance by the drawee-banker. The banker who buys this commercial bill will handle it in much the same manner as he would a bankers' long bill of the kind discussed in the preceding section; he will forward it to his foreign correspondent, have it discounted in the money market abroad, and add the proceeds of the discount to his foreign credit. His buying price will be computed from the same costs as in the case of a bankers' long bill, but he will be compelled to bear one additional charge and this will reduce his quotation a little below the rate for bankers' long bills. This type of commercial bill bears a banker's acceptance and, consequently, commands the same rate of discount as a bankers' long bill; the stamp charges will also be the same; but the foreign correspondent will be compelled to handle the documents which accompany the bill and will charge an additional commission for this service.

To illustrate the buying price for the commercial bill drawn upon a banker, we may take the figures used in the preceding section: discount rate, 3 per cent; stamp tax, $1/20$ per cent; sight rate, 4.85. The extra commission charge varies in practice, but we may assume a customary figure, $1/32$ per cent. The calculation, then, proceeds as follows:

CALCULATION OF RATE FOR COMMERCIAL LONG BILL DRAWN ON
A BANKER

Sight rate of the day of purchase.....	4.85
Subtract charges per pound of bill:	
Discount ($63/365 \times 3/100 \times 4.85$).....	.0251
Stamp tax ($1/20$ per cent $\times 4.85$).....	.0024
Commission ($1/32$ per cent $\times 4.85$).....	.0015
Total subtraction.....	<u>.029</u>
Rate for the commercial bill.....	4.821

In practice some allowance is made by the buying banker for the fact that the credit rating of the drawer of the commercial long bill is somewhat lower than that of the drawer of a bankers' long bill. We shall explain in a later chapter the process of negotiating these commercial bills drawn on bankers. The buying banker will demand proof that the drawer is entitled to place the foreign bank in the position of drawee; when given this proof, he will readily negotiate the bill, but he cannot overlook the fact that its maker, being a business man, does not possess the credit standing of a drawing banker. It is the practice for the buying banker to base his purchase price upon the rate for bankers' long bills, allow for the commission charge, and offer a rate somewhat lower than that resulting from the calculation given above. The drawer of the bill will obtain a number of bids from competing buyers and sell at the highest rate offered.

The other chief type of commercial long bill, the *trade acceptance* drawn by one business man upon another, is almost invariably supported by collateral security in the form of shipping documents. For our present purpose, we have divided these trade acceptances into two sub-groups: the *payment bill* whose documents are surrendered only when

payment is made by the acceptor; and the *acceptance* bill whose documents are surrendered at the time of acceptance. This distinction very materially affects the salability of the bill. With regard to the first of these sub-groups, it may be said that trade acceptances whose documents are retained until payment are not usually purchased by the bankers; the primary reason for this being the fact that such bills cannot be discounted in the money market after acceptance. It is the practice of the exchange market to extend to the drawee of such a bill the option of *prepaying* before maturity, in case he wishes, by so doing, to gain possession of the documents which are attached to the bill. To enable him to exercise this option, the drawee must know where his bill is held, and the necessity of keeping him informed on this point obstructs its free passage through the discount market. Furthermore, money-lenders do not care to invest in assets whose date of payment is indeterminate, and so little demand exists for these "payment" bills which carry the option of prepayment at the pleasure of the drawee. Now, for a banker to buy a long bill which cannot be discounted necessitates a decision on his part to *invest* in the bill, since it cannot be used at the time of acceptance to increase his foreign balance, and is, therefore, not available as cover for sight drafts. But the bankers, like the money-lenders in the discount market, do not wish to hold assets whose maturity date is indeterminate; hence these bills are not often bought from the drawers, but are taken only for collection. We may say of this sub-group, therefore, that it has no true rate of exchange.

The second sub-group of trade acceptances — those which are clean after acceptance — are not debarred from the discount market and, consequently, are frequently bought by the bankers. But the rates of discount at which they are sold in the foreign money market vary in conformity with the credit standing of the acceptor, and the buying prices vary in harmony with this factor. Furthermore, the buying banker adjusts his price as a measure of his confidence in the drawer on whose account he is negotiating the bill and upon whom he will rely to make good any loss arising from dishonor

by the drawee. Accordingly, there is no fixed rate of exchange for bills of this group; bargain between drawer and banker, in which the latter gives full weight to all credit factors peculiar to the bill offered for sale — credit rating of drawer and drawee, discount rate of the foreign money market, character of the goods which serve as collateral security, etc. — will result in a quotation. Only when the standing of the two parties is of the highest order, whose commercial paper commands a definite rate of discount in the money market, can anything like a normal rate of exchange for the bill be said to exist. When this is true, the buying rate will be calculated from the same costs as those which determine the rate of exchange for bills drawn by business men on banks; a higher discount rate will be used and the buying price will be proportionately lower.

In summary of our discussion regarding the schedule of rates upon different classes of bills, we may gather together in the form of a typical schedule the results of our computations.

SCHEDULE OF STERLING RATES IN THE NEW YORK MARKET

Sight rate (bankers' demand drafts).....	4.85
Cable rate.....	4.855
Rate for bankers' long bills.....	4.8225
Rate for commercial long bills:	
(a) Bankers' acceptances.....	4.8210
(b) Trade acceptances	
(1) Payment bills.....	no rate
(2) Acceptance bills: variable rates, with a normal the same as bankers' acceptances with allowance for variation in the rate of discount.	

This interrelation between the rates for different kinds of bills is so close that it is possible to speak of a normal *parity* between these rates. Taking bankers' demand drafts as the norm, the parity for the other rates is determined as follows:

- (A) *Parity cable: demand.* The spread increases or decreases as the New York interest rate increases or decreases; and as the mailing time to the foreign market increases or decreases.

- (B) *Parity bankers' long: demand.* Bankers' long is at par with bankers' demand when its price is equal to the demand price discounted for the period it runs at the arrival rate in the foreign market, with an additional allowance for the foreign tax rate.
- (C) *Parity commercial long: demand.* Commercial long is at par with bankers' demand when quoted at the same rate as bankers' long minus allowance for the commission charges and for the lower rating of the drawer. If the commercial bill is not marketable, it may be said to have no par rate.

As an example of a typical exchange market report, we take the following from the *New York Times* for August 6, 1921:

FOREIGN EXCHANGE

After the brief activity of Thursday, in which sharp advances were recorded in all principal exchanges, the foreign exchange market again settled back into the doldrums yesterday, and fluctuations were minor ones, with the market again entirely neglected. The opinion is general that the market was supported on the previous day, when a settlement of \$5,000,000 was made by Germany with the Bank of England and the Bank of France, in dollars deposited in the Federal Reserve Bank of New York. At any rate, there was no pressure on either side yesterday, and at the close of the day quotations were approximately where they had started.

FRIDAY, AUGUST 5, 1921 RANGE OF RATES, SIGHT EXCHANGE

	<i>High</i>	<i>Low</i>	<i>Final</i>	<i>Thursday's Final</i>
London.....	\$ 3.59 $\frac{3}{4}$	\$ 3.59 $\frac{1}{2}$	\$ 3.59 $\frac{3}{4}$	\$ 3.59 $\frac{3}{4}$
Paris.....	7.74 $\frac{1}{2}$	7.72 $\frac{1}{2}$	7.73 $\frac{1}{2}$	7.75 $\frac{1}{2}$
Rome.....	4.30	4.29	4.29 $\frac{1}{2}$	4.33 $\frac{1}{2}$
Amsterdam.....	30.63	30.55	30.57	30.58
Berlin.....	1.24	1.23 $\frac{1}{2}$	1.23 $\frac{1}{2}$	1.23 $\frac{1}{2}$
Madrid.....	12.89	12.83	12.84	12.87

CLOSING RATES

Parity of exchange is given as reported by the U.S. Mint, except in countries with a silver standard, where parity fluctuates with the price of silver.

EUROPE			EUROPE		
	Friday	Week ago		Friday	Week ago
Sterling — Par \$4.86 5-8 per sovereign.			Serbia — Belgrade — Par 19.3 cents per franc.		
Demand	3.59 3-8	3.55 3-4	Demand	2.25	2.25
Cables	3.59 7-8	3.58 1-4	Cables	2.26	2.26
Comm. 60 days	3.58	3.52 1-4	Spain — Par 19.3 cents per peseta.		
Comm. 90 days	3.64 1-2	3.50 3-4	Demand	12.84	12.82
France — Par 19.3 cents per franc.			Cables	12.85	12.83
Demand	7.73 1-4	7.68 1-4	Sweden — Par 26.8 cents per krone.		
Cables	7.74	7.69	Demand	20.45	20.35
Italy — Par 19.3 cents per lira.			Cables	20.50	20.40
Demand	4.29 1-2	4.18 1-2	Switzerland — Par 19.3 cents per franc.		
Cables	4.30	4.19	Demand	16.58	16.38
Belgium — Par 19.3 cents per franc.			Cables	16.10	16.40
Demand	7.41	7.34			
Cables	7.42	7.35			
Germany — Par 23.8 cents per mark.					
Demand	1.23 1-2	1.23 3-4			
Cables	1.24	1.24 1-4			
Austria — Par 20.3 cents per crown.					
Demand	.11 1-4	.12			
Cables	.11 3-8	.12 1-2			
Czechoslovakia — Par 20.3 cents per crown.					
Demand	1.27	1.26			
Cables	1.29	1.27			
Denmark — Par 26.8 cents per krone.					
Demand	15.30	15.12			
Cables	15.35	15.17			
Finland — Par 19.3 cents per finmark.					
Demand	1.55	1.57			
Cables	1.58	1.58			
Greece — Par 19.3 cents per drachma.					
Demand	5.52	5.58			
Cables	5.55	5.61			
Holland — Par 40.2 cents per florin.					
Demand	30.57	30.73			
Cables	30.59	30.75			
Hungary — Par 20.3 cents per crown.					
Demand	.26	.27 1-2			
Cables	.26 1-2	.27 3-4			
Jugoslavia — Par 20.3 cents per crown.					
Demand	.56 3-4	.56 1-4			
Cables	.56 7-8	.56 3-4			
Norway — Par 26.8 cents per krone.					
Demand	12.75	12.75			
Cables	12.80	12.80			
Poland — Par 23.8 cents per crown.					
Demand	.05 1-4	.05			
Cables	.05 3-8	.05 1-2			
Rumania — Par 19.8 cents per leu.					
Demand	1.26	1.25 1-4			
Cables	1.28	1.26 1-4			

PAR EAST		
China — cents per silver dollar. Hongkong;		
per tael Shanghai and Peking.		
Hongkong		
Demand	51.00	50.50
Cables	51.10	50.60
Peking		
Demand	74.50	73.50
Shanghai		
Demand	71.50	70.50
Cables	72.00	71.00
India — Calcutta, cents per rupee, nominally		
stabilized at one-tenth of a pound sterling.		
Demand	23.50	23.125
Cables	23.75	23.25
Philippine Islands — Manila: par 50 cents		
per silver peso.		
Demand	48.00	48.50
Cables	48.25	48.75
Java — Par 40.2 cents per florin.		
Demand	32.00	32.00
Japan — Par 49.8 cents per yen.		
Demand	48.50	48.125
Cables	48.75	48.375

SOUTH AMERICA		
Argentina — Par 42.44 cents per paper dol-		
lar.		
Demand	28.75	29.125
Cables	28.875	29.25
Brazil — Par 32.45 cents per paper milreis.		
Demand	12.25	11.125
Cables	12.875	11.25

CANADA		
Montreal — Par 100 cents per Canadian dol-		
lar.		
Demand	89.3	88.6

26. Arbitrage. Within a given market, the schedule of rates applying to the different kinds of bills holds together in a fairly fixed relationship, rising and falling in unison under

the influence of the forces of supply and demand which play upon the rate for bankers' demand drafts or checks. We have now to see that the rates in different markets at the same time are related to each other; and, also, that within the same market a relationship exists between the schedule of rates at one time and the schedule at other times. That is to say, sterling rates in the New York market on a given date and dollar rates in the London market on the same date tend to coincide; also, sterling rates in the New York market on this date will be related to the sterling rates on preceding dates and their expected position on subsequent dates. These interrelations between the rates of exchange at different times and places are brought about through the forces of arbitrage and speculation. Arbitrage transactions of exchange dealers bring the schedule of rates in different markets into harmony with each other at a given time; speculation brings into relationship the rates present, past, and future within a given market.

In introducing the subject of arbitrage, it is necessary at the outset to explain that arbitrageurs deal in cables alone, so that the effect of their operations is exerted solely upon the cable rate. Furthermore, it is essential to see that for each quotation on sterling cables in New York there is an exactly equivalent quotation on dollar cables in London, and similarly with other foreign exchanges. The effect of arbitrage transactions is to bring the pair of quotations into equivalence with each other when they chance to diverge from their true position. First let us illustrate what is meant by equivalent quotations. Assume that sterling cables are quoted in New York at 4.85; the pound sterling contains 240 pence; if the pound is worth \$4.85 in New York, the dollar in London, to be equivalent in value, should be worth 49.48 pence ($240 \div 4.85$). To vary the illustration, assume that franc cables sell in New York at 19.5 cents per franc; to be equivalent in value, the dollar in Paris should, under these conditions, sell for 5.12 francs ($100 \div 19.5$). And so for every other possible quotation on foreign cables in New York, however unusual or abnormal the quotation, there is a rate in the foreign

center which will represent an equivalent value for the dollar cable. Arbitrage transactions spring up when the pair of rates diverge from this position of equivalence and have the effect of bringing the two quotations into conformity with each other.

The key to the cause and the effect of arbitrage transactions lies in this significant fact: that if the pair of rates diverge from their true position, the effect will be either to make both appear cheaper than they should be, or else to make both appear dearer than they should be. That is to say, if the sterling cable rate in New York and the dollar cable rate in London lose their equivalence, sterling cables will either appear to New York dealers to be selling below their true value and dollar cables will at the same time appear to London dealers to be selling below their true value; or else, the reverse will be true in both markets and the two cables will appear to be selling above their true value. To make this clear, let us return to the quotations assumed above. If sterling cables are quoted in New York at 4.85, dollar cables should be quoted in London at 49.48 pence. Now, let these quotations lose their equivalence, the sterling rate in New York remaining 4.85 and the dollar rate in London falling to 49 pence. Then look at the situation through the eyes of a New York dealer; dollars are quoted at 49 pence in London; hence sterling cables *should be* selling for 4.89 ($240 \div 49$); but they are actually quoted at 4.85, hence they appear cheaper than they should be. Look, again, at the same situation from the viewpoint of a London dealer; he knows that the sterling cable rate in New York is 4.85 and that to be equivalent the dollar cable rate in London *should be* 49.48; but the dollar rate is actually 49; hence dollar cables appear cheaper than they should be. If the divergence had been in the opposite direction, both rates would have appeared too high rather than too low; but, for the sake of simplicity, we may postpone a consideration of that condition until we have discussed the activities of the dealers in the case represented above; that is, when in each of the two markets exchange drawn on the other appears to be selling below its true value.

Arbitrage transactions are carried on by two men, each located in one of the two markets concerned, who coöperate for mutual profit. It is their intention so to conduct their transactions that the operations carried on by one will offset those carried on by the other. Thus, when the rates in both markets appear too low, both arbitrageurs will buy cables to remit to each other for encashment; each will expend money in the purchase of exchange, but each, also, will receive from the other the cable transfer which the latter buys and so have in hand funds to cover his expenditure. Assume, now, that the exchange markets of London and New York are in the condition pictured above: sterling cables in New York quoted at 4.85 and dollars in London at 49 pence; both, therefore, appearing cheaper than they should be. If the arbitrageur in New York buys \$10,000 worth of sterling cables at 4.85, he can place in the hands of his London partner £2061 12s. 4d. If the correspondent in London buys a \$10,000 cable, it will cost him £2041 13s. 2d. Each will send his cable transfer to the other; the arbitrageur in New York will, accordingly, receive from London an amount exactly equal to that he expends on sterling cables; but the London arbitrageur will receive from New York approximately £20 more than he expends. This twenty pounds is profit for the two arbitrageurs. Because the two cable rates appeared low, both arbitrageurs bought; hence they have operated to raise the rates and restore equivalence between them.

The divergence between the cable rates may be such as to make both appear too high; in this case the arbitrageurs will be tempted to sell simultaneously, rather than to buy, as in the preceding example. For example, assume that sterling cables in New York are quoted at 4.85 and that the dollar cable rate in London has *risen above* the point of equivalence, say to 50 pence. From the point of view of a New York dealer, sterling cable rates now appear higher than they should be; for with dollars quoted at 50 pence in London, the sterling rate should be 4.80, instead of 4.85 ($240 \div 50$). In London, the dollar rate appears equally dear; for when sterling cables sell for 4.85 in New York, dollar cables in London

should sell for 49.48 pence and not for 50 pence. Since the two rates are both higher than they should be, both arbitrageurs are tempted to sell and will do so, if their transactions can be so conducted as to offset each other.

This offset may be brought about as follows: let each arbitrageur sell a cable drawn on the other. Each will then be compelled to redeem the other's order, but will be prepared to do so out of the funds raised through the sale of his own cable. Suppose, then, that the New York arbitrageur draws and sells a sterling cable for 10,000 pounds payable by his London correspondent; with the rate at 4.85, he will realize \$48,500 from the sale. If the London correspondent draws a dollar cable for this amount (\$48,500) on his New York partner, he can sell the order for £10,106.16 ($48,500 \times 50d.$). In redeeming this cable drawn upon him, the New York partner will expend all that he realizes from the sale of his sterling cable; the London partner, on the other hand, will be called upon to redeem a cable of £10,000 whereas, from the sale of his dollar cable, he will have realized £10,106.16. Thus a profit of approximately £106 remains to be divided between the two arbitrageurs. Rarely do the rates diverge to the extent assumed in the preceding illustrations, for arbitrage transactions involving large sums spring up whenever the slightest discrepancy appears. But these operations must consist either in buying when the rates are below their true position, or of selling when they are above their true position; thus the arbitrageurs will force the rates up, or down, until they are in equivalence with each other.

By an extension of the arbitrage process, the cable rates of all markets connected by unrestricted communication will be brought into harmony with each other. Just as, between two points, there is a pair of quotations which express exact equivalence between the cable rates, so among the quotations in three, four, or more markets, there is a position of equivalence toward which the rates tend. Let us suppose, for example, that in New York the sterling cable rate is 4.85 and the franc cable rate fr. 5.18; under these conditions the sterling cable rate in Paris *should be* fr. 25.12 per pound. For if each dollar

is worth 5.18 francs and the pound is worth \$4.85, the price of the pound in francs, to be in harmony with this pair of rates, should be fr. 25.12 (4.85×5.18). Assume, now, that the sterling rate in Paris moves from this position — say to fr. 25; arbitrage transactions involving New York, London, and Paris will immediately spring up. A New York dealer with connections in Paris and London may sell a sterling cable for £10,000 and realize \$48,500, covering the cable in London by buying another sterling cable for the same amount in Paris at a cost of fr. 250,000. The cable sold in New York will be addressed to the London correspondent and the one bought in Paris will be sent to this correspondent for encashment in time to offset the order from New York. Funds must be placed in Paris to meet the cost price of the sterling cable bought there, and this can be done by remitting a franc cable from New York for the required amount — fr. 250,000. The buying of this franc cable will cost \$48,324.32, since the franc rate in New York at this time is 5.18. The transaction will show a profit as follows: income from sale of sterling cable in New York, \$48,500; cost of cover (francs bought in New York, turned into sterling in Paris and sent to London), \$48,324.32; profit, \$175.68.

In this illustration, the sterling cable rate was dearer in New York and cheaper in Paris; but in putting through the arbitrage operation, the bankers will have appeared on the supply side of the dearer market by offering sterling for sale in New York, and on the demand side of the cheaper market by buying sterling in Paris. The tendency of such transactions will be to raise the cheaper and lower the dearer rate, thus bringing them into uniformity with each other. So keen is the watch kept by the arbitrageurs on all the markets of the world that discrepancies of any magnitude rarely appear. Experts in arbitrage operations will put through transactions involving four or more markets if an opportunity for profit arises. Only in abnormal times, when communication is broken or hampered, or when the normal rates of exchange have been abrogated, do these transactions fail to bring into harmony with each other the quotations in the different markets at a given time.

27. **Speculation** is buying at one time and selling at another. The sale may occur before the purchase, as when the speculator "goes short" of the article, by selling at a fixed price something which he does not possess, in the hope of being able to buy at a profitable price before he is obliged to make delivery. Or the purchase may precede the sale, as when the speculator buys an article with the intention of holding it for resale at a higher price. The economic effect of speculative transactions in the exchange market, as in other things, is to produce a tendency toward uniformity in the rates over periods of time by increasing the demand when bills are cheap, and the supply when they are dear.

Many of the most customary transactions in the exchange market contain an element of speculation, though they are not carried on for the primary purpose of gaining profit from the speculative risk. Whenever a banker buys a bill of exchange for investment, holding it until maturity instead of discounting it after acceptance, he usually does so with the primary purpose of gaining interest on the money he expends. But unless he assures himself at the time of buying the bill of the rate at which he will be able to draw his demand drafts when the bill matures, his gains will be affected by the position of the sight rate at a future date. Again, when a banker increases his foreign balance by buying bills for discount at a time when there is little demand for his sight drafts, he usually is paid interest by the foreign correspondent on the balance, or a portion of it. However, it is not probable that he would do this for the gain of interest alone; he will, no doubt, expect rising rates of exchange in the future and hope to turn his foreign balance to good account later on. Here the motive is a mixture of desire to take a speculative risk and desire to gain interest. But for the readiness of bankers to buy bills when they are plentiful and hold them to maturity, or allow the credits which they create to lie comparatively idle abroad, the exchange rates would be subject to much more frequent and violent fluctuation.

On the other hand, when the rates are high, but seem likely to fall, bankers may create a supply to meet the oc-

casion by borrowing from their foreign correspondents. The loan takes the form of a banker's long bill drawn upon and accepted by the foreign correspondent, and sold in the discount market abroad after acceptance; the drawing of such bills by the bankers adds to the supply on the market and tends to lower the rates. But the borrowing banker obligates himself to cover the bill at maturity by placing sight drafts in the hands of his correspondent, and this necessitates his buying in a low market. In this transaction, interest is gained; and again we find a mixed motive actuating the bankers.¹ Many other transactions are carried on in the exchange market, not for the sake of the speculative risk, or only partially for the sake of this risk; reference will be made to the speculative character of these transactions at different points in the following chapters.

However, the term *speculation* is usually applied only to those dealings in the exchange market whose sole, or principal, motive is the promise of gain which the speculative risk holds forth. The typical transaction of this kind involves the purchase or sale of a *future* contract; that is, a contract which binds one party to deliver a specified amount of exchange to the other at a specified rate and upon a stated date in the future. Exchange dealers who give or take these contracts conduct two kinds of operations in futures: those which are *uncovered* at the time the contract is formed; and those which are *covered*. An uncovered transaction in futures may involve either the purchase or sale of exchange by the banker. For example, a merchant who will ship goods at some future date, and will have bills for sale at that time, may wish to be relieved of the risk of a possible decline in the rate of exchange. Accordingly, he places with his banker now a promise to deliver a certain amount of foreign exchange on the day when shipment will be made, the rate of exchange being agreed upon between banker and merchant and written into the contract. If the banker elects to take the risk of being unable to sell his own demand drafts at profitable rates on the day when the merchant will deliver the exchange,

¹ See discussion of finance bills in Chapter VI.

he leaves the future uncovered; that is, he does not now sell his own contract to deliver the exchange to some one else. It is obvious that he will run this risk only if he has reason to believe that the rate of exchange will rise in the meantime, thus bringing him better terms for his demand drafts than he could get now on his contract to deliver exchange at the future date.

A *sale* of an uncovered future by a banker is the reverse of this transaction. The banker places his promise to deliver a certain amount of exchange at a fixed rate on a stated future day, trusting to be able to buy the required cover some time before he is called upon to deliver and at a rate low enough to return a profit. The buyer of a banker's future may be another banker or a merchant who has a remittance to make at the future date and wishes to know in advance how much the remittance will cost. A banker will leave this future uncovered only if he is convinced that the rates of exchange are about to decline, just as he will buy an uncovered future only if he believes the rates are to rise. But operations of this sort on any considerable scale must necessarily result in diminishing the difference between the rates at different times, since they tend to increase the supply of bills when rates are high and to increase the demand for them when rates are low.

The risk involved in dealing in uncovered futures is so great that bankers usually close out such transactions by providing an immediate offset to each transaction. There are different ways of doing this, one of which is to bring the purchase and sale of futures together into one transaction so that the one future will cover the other. For example, upon buying the merchant's future in the preceding illustration, the banker may immediately sell his own contract to deliver a like amount of exchange at the same future date. If he can get a little better price for his own bills than he gives for the merchant's, the banker will reap a profit from the transaction and will run no risk of loss from fluctuations in the rates of exchange; for the bills which he has agreed to buy will offset those he has agreed to sell. To make sure of this profit, the banker will inform himself of the rate his own future will command before offering a price to the merchant.

A variation of the covered future is found in those transactions in which bankers' futures are sold against purchases of commercial bills of various maturities. Thus, when a New York banker buys an assortment of sterling bills which mature at different future dates, he can determine approximately what credit the bills will give him and sell now his promise to deliver a corresponding amount of demand drafts on these dates, and so be assured of his ability to draw upon profitable terms against his London credits. In this case, he will have obtained cover for his future in advance and will have eliminated the risk of fluctuation in the exchange rates. Such dealings in covered futures do not seem at first sight to cause a real addition to either demand or supply of bills of exchange, since each transaction affects both sides of the market equally. But they none the less contribute toward the development of a broad market in which bills may be bought and sold with greater confidence, and this broadening of the market tends to prevent the excessive pressure of demand or supply which would appear periodically if business men whose transactions involved the purchase or sale of bills of exchange were denied the insurance against risk afforded by dealings in futures. In the broader and more stable market, sudden and violent fluctuations in the rates of exchange are prevented.

Thus far we have considered only those forms of speculation which are practiced by bankers and dealers in foreign exchange as an incidental part of their regular business. There are other people in the exchange market whose sole activity is speculation of one kind or another. Some of these are operators in the stock and produce exchanges who enter the exchange market for speculative purposes whenever conditions appear to hold forth promise of profit from buying or selling bills of exchange; others are from the outside, people with money to risk in a gamble on the trend of the exchange rates, who buy and sell more or less blindly. Speculators of both types flourish when the fluctuations of the exchange rates are erratic; their profit depends upon rapid changes in the quotations and they quickly withdraw from a quiet or

stable market, leaving the business in the hands of the regular bankers and dealers. An operator whose sole purpose is speculation has no use for the bills of exchange which he buys, other than the intention to sell them again at a higher quotation; nor has he any power to add to the supply of bills by drawing against a foreign credit. When he sells, he sells "short" of exchange; that is, he sells a promise to deliver bills which he has no power to create, relying upon a drop in the exchange rates to enable him to buy cover upon profitable terms from the supply already in existence. These activities appear to be nothing else than mere gambling, performing no useful function to society and wasting the time and energies, and often the money, of those who practice them. But this judgment is not always, nor even usually, correct; speculation in bills of exchange may be beneficial to society, or it may be harmful, depending upon whether the speculators have correctly forecast the movement of the rates.

When the rates of exchange are, for any reason, subject to sudden and extreme fluctuations, the speculators attempt to turn the situation to account by buying in bills of exchange when they expect an upward turn in the rates, and selling short when they believe the tendency is downward. If their predictions are substantiated by the event, the fact that they have bought exchange when it was cheap will cause them to sell on the rising market; while, on the other hand, the fact that they have sold short when the rates were high will force them to buy in the falling market to cover their sales. In either case, the effect of their operations will be to restrain the fluctuations of the rates, since they will have added to the demand when prices were falling and to the supply when prices were rising. If, however, they have misjudged the tendencies and have bought when rates were about to fall, or sold short when rates were about to rise, their activities will increase the fluctuations; for in the first case, they will be forced to sell in the falling market, and, in the second, to buy in the rising market. Ignorant and ill-conceived speculation is, therefore, a disturbing factor in the exchange market; but it carries its own penalty, since the speculator's money is lost

when he misjudges the tendency of the rates of exchange. On the other hand, when the speculator's forecast proves to have been correct, and his operations result in profit for himself, his buying or selling of exchange will have served to add stability to the market and to prevent extreme quotations.

Since the Great War, the market for European bills of exchange in New York has been extremely abnormal. The unbalanced trade of the United States with Europe, coupled with the suspension of specie payments abroad, has flooded the market with an excessive supply of commercial bills, a supply which the bankers have been unable to absorb, and the rates have fallen to unprecedented discounts. These abnormalities have been a temptation to the speculators in exchange, both the regular operators in New York and people from the outside. There is reason to believe that their activities have been, on the whole, beneficial. The extreme movements of the rates have not, in any case, been *caused* by the speculators, but by the basic forces of supply and demand; while the fact that the low rates have encouraged speculative buying has brought some measure of relief to the disturbed market by removing a portion of the excess supply of bills.

CHAPTER V

THE RATES OF EXCHANGE AND THE CURRENTS OF COMMERCE

28. Fluctuations of the rates caused by the balance of payment. Two forces play upon the rates of exchange and cause them to rise above or fall below par. One of these forces may be properly called a *currency factor*; it is brought into play by the breakdown of the gold standard of monetary payments in one or both of the countries to which the rate applies, and the inflation of that country's currency through the issue in excessive amount of an irredeemable paper money. The other force may be called a *commercial factor*; it arises from the balance of payment between the two nations left uncanceled from the complex of transactions which comprise their foreign commerce. We shall postpone an examination of the former of these forces to a later place in this chapter. In the discussion which follows, it will be assumed that the commercial factor, alone, is operative.

The statement that variations of the rate of exchange are caused by the balance of international commerce is correct only when the term *commerce* is used in its broadest sense to include all transactions which require payment from individuals in one country to those in another. These transactions must comprise the so-called "invisible" items in foreign trade — the purchase of services of all sorts, the lending of capital by one country to another, remittances made by governments, travelers, immigrants, and so forth — as well as the importation and exportation of goods. When, a result of these different activities, the people within a country have more payments to make to foreign creditors than they are entitled to receive from foreign debtors, the rates in that country on foreign bills of exchange will rise, while, in other markets, the rates on that country's bills will fall. Con-

versely, when the people within a country have more payments to receive than to make, foreign bills will be quoted at falling rates in her market, while bills drawn upon her will be quoted at rising rates abroad. This controlling factor, the balance of payment, works out its effect through the medium of the bankers whose selling rates for their demand drafts govern the exchange market. When the balance is in the nation's favor, the bankers will be supplied with unused credits in foreign cities — credits placed there through the purchase of the bills of exporters and other creditors; unused, because importers and other debtors will have discharged all their foreign obligations without exhausting the bankers' foreign balances. In an effort to avail themselves of these excess credits, the bankers will offer their demand drafts at lower rates of exchange. On the other hand, when the balance of the nation's commerce is unfavorable, the bankers will be pressed to draw foreign drafts faster than their foreign balances can be repaired through the purchase of exporters' bills; their reaction to this situation will be to offer their demand drafts at advancing rates of exchange.

So far as the bankers are concerned, the rise and fall of the rates of exchange exert a doubly corrective effect upon the condition of the foreign balance. When foreign credits are unduly large, the falling sight rate tends to expand the sale of bankers' demand drafts by means of which these credits are reduced, and to retard the offerings of exporters' bills by means of which they are increased. Conversely, the rising rate, when foreign credits are unduly small, diminishes the demand for bankers' sight drafts and stimulates the offerings of bills for sale to the bankers. But, since the basic cause of the condition of the bankers' foreign credits is an unbalanced state of the nation's foreign commerce, the only effectual corrective is to bring this commerce more nearly to a state of equilibrium. So long as the people within the country continue to buy more than they sell (measuring both imports and exports in terms of value), or to sell more than they buy, foreign credits must remain either scarce or redundant, and the rates of exchange must be held more or less permanently at a

premium or a discount. This shows the significance of the specie points. When other correctives fail to restore to equilibrium the foreign commerce of the nation, gold will move in sufficient quantities to offset the balance, flowing out of the country whose purchases of all sorts so far outweigh her sales as to force the exchange rates on foreign bills to the specie exporting point; and into the country whose sales exceed her purchases so much that the rates fall to the specie importing point.

Irresistible economic forces are, therefore, working to bring the foreign commerce of the nation to a balance; no group of producers will be content to give away its goods, service, or property rights; payment in some form, or, at least, satisfactory promise of payment, will be insisted upon. A rising exchange rate on a nation's bills is an indication that that nation has been selling to foreign peoples more than it has received payment for; the reverse is shown by a falling rate on a nation's bills; either condition is abnormal and temporary.

29. Reaction of the rates of exchange upon the currents of trade. This explanation of the commercial forces which cause fluctuations of the rates of exchange exhibits these fluctuations as the *result* of variations in the currents of international commerce. But the relation between the rates of exchange and the foreign commerce of a nation is not a simple one; we have now to see that the rates, caused by the balance of payment, react upon the currents of commerce and produce changes in the balance of payment. When foreign bills are at a discount in the New York market, the low rates of exchange tend to stimulate imports and to restrict exports in the foreign trade of the United States, and thus to reduce the favorable balance of trade which is the initial cause of the discount; conversely, a premium on foreign bills acts as a stimulus to exports and a restriction upon imports, tending in this manner to reduce the unfavorable balance of payment. Under normal conditions, when gold is moving freely between the nations, and the rates of exchange are confined within the narrow range set by the specie points, this reaction of the rates upon the balance of payment may be imperceptible; but when the limits are removed and the rates

are permitted to move to abnormal premiums or discounts — and this has been true the world over since the Great War — their influence upon the currents of international commerce becomes apparent and important.

The reaction of the exchange rates upon the nation's commerce will become clear if we place ourselves in the position of a merchant whose business brings him into the exchange market as a buyer or seller of bills, and consider the effect of the position of the exchange rates upon his transactions. Let us assume that this typical merchant is trading with Great Britain at a time when sterling bills are selling at a premium in New York. With exchange in this position, the merchant may make a double profit from his sales in England. His normal trading profit is included in the sale price of his goods and is, therefore, included also in the face of the sterling draft which he draws. In turning this draft into dollars at the prevailing high rate of exchange, a second profit is derived from the fact that each pound sterling is worth more dollars than normally. Now, if the merchant is free from competition, he can retain this double profit for himself, and he will, accordingly, have an increased incentive to sell goods in England. If, however, as is usually the case, he is in active competition with other exporters, the profitable market for American goods in England will result in lower sale prices to the benefit of English buyers; but this condition, also, will increase our exports, since it is axiomatic that more goods can be sold at a low than at a high price. The same result — increased exports from the United States to England — will occur if payment is made by remittance of dollar drafts by the English buyers; for when sterling exchange is at a premium in New York dollar bills sell at a corresponding discount in London, and the purchase of these bills at low rates by English importers as a means of making payment for American goods reduces the cost of the goods and encourages their importation. As an exporter, the New York merchant either gains an unusual profit when sterling rates are high or finds his goods in larger demand because their cost has fallen; in either event the high rates stimulate his foreign sales.

The position of the importers of English goods is the exact reverse when sterling exchange sells at a premium. Payment will be made by the importer, either by remittance of sterling sight drafts from this side, or by the redemption of a bill drawn in dollars by the English exporter. If the former method be adopted, the cost of English goods to the importer will rise, even when the price quoted by the seller does not change; for the premium on sterling drafts must be paid when the importer buys exchange to discharge his obligation under the terms of sale, and this virtually increases the cost price of his goods. Similarly, if payment is made by draft of the exporter, the premium on sterling exchange will increase the costs of the goods to the importer. In this case, there will probably be a definite and open rise in the sale price quoted by the English exporter; for he will expect to receive a certain amount in pounds for each unit of his goods, and, when dollars are at a discount, he must raise his selling price, quoted in dollars, in order to be assured of a profit. Under either situation, therefore, the premium on sterling exchange tends to restrict imports into the United States from England. It has been said above that these influences of the rates of exchange upon the currents of trade are, under normal conditions, so slight as to be imperceptible. It should be borne in mind, however, that this is true only because gold is permitted to move in sufficient quantities to restore equilibrium in international commerce; when, from economic necessity or national policy, gold is prevented from supplying this corrective, the exchange rates will, themselves, exert the needed corrective influence through their tendency to increase imports and diminish exports, or *vice versa*. It is a simple and fundamental, but frequently forgotten, law of international trade that payments must balance.

30. Fluctuations of the rates caused by a depreciated currency. The rates of exchange are prices for a particular kind of credit instrument, and, like all other prices, are controlled solely by the forces of supply and demand. Only the commerce of the nation — using that term in its broadest sense — can affect either the supply of bills of exchange or the demand

for them; hence, all *true* fluctuations in the rates of exchange must be attributed to the commercial factor discussed in the preceding section. But apparent fluctuations are caused by another factor — the presence in one or both of the nations concerned of an inflated and irredeemable paper money; and, unfortunately, no attempt is made in the exchange markets to distinguish these apparent fluctuations from those movements which have a commercial origin. Yet they are essentially different both in their nature and in their reactions upon the currents of trade between nations and it is important that this difference be understood. When discussing this subject in another chapter,¹ we tried to make clear the fact that a discount on a nation's bills which appears in foreign markets when that nation is using a depreciated paper currency, is not a true discount, but an indication of a new par rate.

Whether the true par of exchange between gold money and an irredeemable paper, or between the irredeemable paper notes of two countries, is calculated on the basis of the premium on gold or on the basis of the relative purchasing powers of the two moneys,² the fact must be recognized that the paper notes are essentially different from the gold coins whose names they commonly bear. Any inferences regarding the effect of exchange rates upon the currents of trade under these conditions will be unsound so long as they proceed from the assumption that the gold pars of exchange are still of significance. When the new par of exchange is derived for the purpose of throwing light upon the trade relations of the countries concerned, it is safer to base the calculation upon the purchasing power parities. Business men are primarily concerned with costs and receipts determined by the purchase and sale prices of their goods; they will be encouraged to increase their exports to a given country, or their imports from that country, by reason of the condition of the exchange market, only if the exchange rates so affect their transactions as to increase the spread between purchase and sale prices so that their profits expand.

¹ See pages 51 f.

² See pages 52 f.

The peculiarity of foreign trade in this respect is this: that purchase prices, on the average, are determined by the price level of one country, while sale prices, on the average, are determined by the price level of another country. Hence, for the spread to increase between these two prices, thus widening the margin of profit between the costs and receipts of the foreign traders, the price levels of the two countries must draw apart; that is to say, the purchasing powers of their moneys must diverge. But if, when such a divergence of the price levels occurs, the difference is all taken up by movements of the rates of exchange, the effect upon the trade relations of the countries will be neutralized. The temptation, then, will be to take note only of the abnormal position of the exchange rates, and, overlooking the fact that any influence of these rates is offset by the relation of the price levels of the two countries, to infer that the exchange market must be exerting a powerful influence either in the direction of stimulating imports or exports. Both of these factors must be taken into account at a time when trade relations are complicated by the presence of an irredeemable paper money. The best way of doing this is, first, to compute the true par of exchange on the basis of the relative purchasing powers of the two moneys and then to compare the current market rates with this new par. If any discrepancy appears, it may be called a true discount or a true premium on the foreign bills, and, since its origin must be, not in the currency, but in the commercial factor, it will exert an influence over the currents of trade between the two nations.

We can best understand why it is that fluctuations of the rates of exchange, produced by the influence of an inflated currency, exert no effect upon the currents of trade, by placing ourselves in the position of a merchant engaged in foreign commerce at a time when the exchange market is disturbed by this factor. Assume that the franc rate in New York shows a discount from the gold par of 50 per cent at a time when the purchasing power parity of the paper franc is exactly 50 per cent below the normal par. An exporter of goods from France to America can now sell his dollar bills at a premium of 100 per

cent; but he will receive paper francs in exchange for these bills and must use this paper money to meet costs which have doubled. Each franc has half the purchasing power that it normally possessed; hence, the fact that the exporter receives for his dollar bills twice as many francs as normally will not avail to increase his profit from the sale of goods to the United States. There will be no inducement for him to lower the sale price of his goods, and we can conclude that the condition of the exchange market will exert no stimulus upon French exports to the United States. A French importer of American goods, on the other hand, must now pay twice as many francs as normally when buying dollar drafts with which to make payment for his imports. But under the assumption that the premium on dollar bills exactly measures the discrepancy between the price levels of the United States and France, this importer will also receive twice as many francs, as he normally received, when he sells his goods in the French market. Hence, the condition of the exchange market will not diminish his profit, and, therefore, will not tend to restrict his importation of American goods. It need not be urged that we speak here of the import and export trade *in general*; dealers in a narrow range of goods may well find that the prices of their particular commodities have not kept pace with the trend of the general price level and that, consequently, the condition of the exchange market is such as either to stimulate or to burden their trade. But considering the commerce of the nations as a whole, the effects will be as stated; when the fluctuations of the exchange rates conform to the purchasing power parities, no influence will be exerted upon the currents of trade.

31. The silver exchanges and their relation to international commerce. Another type of currency factor is to be found in the case of the silver exchanges. The relations of a gold standard country with a silver standard country are very similar to its relations with a country whose money is an irredeemable paper in that in both cases there is a fluctuating par of exchange and the market rates are subject to wide variation due to this fact. In both cases, also, there is the temptation to

draw hasty conclusions from the evidence of the exchange rates regarding the profitableness of export and import trade with the nation concerned. Between June, 1918, and June, 1919, for example, the market rates in New York on Shanghai exchange rose from \$113.50 for 100 taels to \$127.00 for 100 taels; during the following year, from June, 1919, to June, 1920, this rate fell from \$127.00 to \$101.00. With attention fixed solely on these quotations, one might readily deduce that the movement of the rates during the first of these two years was such as to encourage the sale of goods in China and discourage importations from that country, while, during the second year, a reverse effect was exerted by the rates. But this conclusion would be founded upon insufficient evidence. It must be remembered that the price levels in these two countries — the United States and China — are not expressed in a common denominator and that their fluctuations are not of necessity uniform. Any effect exerted by the exchange rates *might* be counterbalanced or more than counterbalanced by offsetting movements of the price levels of the two countries, in the same manner as that discussed in the preceding section with reference to the paper standard countries. With the silver exchanges as with the paper money exchanges, the movements of the rates must be compared with movements of the purchasing power parities of the two moneys before reliable conclusions can be drawn regarding the effect of the exchange market upon the currents of commerce. The statement may be repeated in this regard, that only *true* discounts or *true* premiums react upon the profitableness of trade.

In concluding this subject of the influence of the currency factor, we may introduce one qualification. It has been said that when fluctuations of the exchange rates conform to changes in the purchasing power parities of the moneys concerned, no influence is exerted upon the currents of trade. This is the long-run view of the matter. But there is a short-run effect which should not be left out of account. After an exporter has named his price and sold his goods, any shift in the exchange rates quoted for the bills he is to draw

will either increase or decrease his profit; and this will be true even though the shift in the exchange rates conforms precisely to changes in the purchasing power parity of the two moneys. For this particular exporter, in this particular transaction, the changing price level is of no moment, since his goods have already been priced. If the foreign rates fall before he can liquidate his transaction, a part of his profit will disappear in the exchange market. Individual importers are in a similar position with respect to particular transactions. It is often the custom to agree to pay a certain price for future delivery and even to resell the goods in the home market on the basis of that price. When a contract of this kind has been formed and the exchange rates suddenly shift, the importer will either lose or gain profit when making remittances to his foreign creditors. Sudden and violent fluctuations, produced by the currency factor, will almost of a certainty find a multitude of importers and exporters with commitments made on the basis of past rates of exchange. It is possible to guard against these risks by selling or buying for future delivery in the exchange market the bills of exchange which will figure as the financing agencies of the transactions about to be formed, thus informing the merchant of the rates of exchange at which he will realize upon his transactions.¹ But unless this is done, the unstable condition of the exchange market will inject a large element of risk into the transactions of the traders. It cannot be said that this short-term effect of the currency factor stimulates exports or imports; rather its effect, unless guarded against, is to discourage *both* import and export trade and thus to exert a repressing influence upon foreign commerce. For this reason it is not a matter of indifference when rates on silver or paper standard countries are shifting rapidly, even though these fluctuations are neither true discounts nor true premiums.

32. National interest as affected by fluctuations of the rates of exchange. We have seen that when exchange drawn on a country sells at a true premium in foreign markets — and foreign bills at a true discount in her own — the situation

¹ See the discussion of hedging, pages 293 f.

is one which encourages the importation of foreign goods and discourages exports. Conversely, that exports are stimulated and imports restricted when the rates on a nation's bills fall to a discount in foreign markets. It is customary to speak of the first of these conditions as *favorable* to the nation, and of the second as *unfavorable*. The reason is that, normally, when foreign rates fall in the home market, there is likelihood of an inflow of gold, whereas when they rise, an outflow of gold may occur; and these events are supposed to be, the one desirable, the other undesirable, from the standpoint of national interest. However, a little thought should make it clear that no nation is benefited by an abnormal condition of the exchange market, whether that condition is such as to cause a premium or a discount on its bills in foreign countries.

When we view the matter from the standpoint of the nation as a whole, and disregard the interest of the individual traders, the rise and fall of the rates of exchange indicate fluctuations of the nation's power to buy the goods of other peoples. Nations export to be enabled to import: purchases of foreign goods and services are paid for out of credit supplied by the export trade. When the exchange rates move against a nation — that is to say, when her bills fall to a discount in foreign markets — the credits created by her export trade shrink accordingly, and the exports will exchange for a proportionately smaller amount of foreign goods and services. To illustrate: Brazil pays for her imports from the United States, in large measure, by exporting coffee. In making payment for their purchases of Brazilian coffee, American buyers create credits in New York in favor of banks in Brazil, and drafts are drawn against these credits for the use of Brazilian importers who have payments to make for goods bought in the United States. If exchange on Brazil falls to a great discount in New York, as it did in the year 1920, less will be paid by the importers of coffee when purchasing bills for remittance to Brazil and, therefore, smaller credits will be created out of which to pay for American goods; in other words, a given amount of coffee will exchange for a smaller amount of the products of the United States. This state of affairs can-

not be called favorable to the interests of Brazil, certainly; although she may be able to increase her sales of coffee because the price of that article measured in dollars has fallen, no corresponding increase of American goods is given in exchange for the larger shipments of coffee. Nations, like individuals, are impoverished by a dwindling of their purchasing power.

On the other hand, it is not beneficial to the interests of the United States that the dollar rate should rise to abnormal premiums in Brazil and other foreign markets. The premium on the dollar — if a *true* premium, and not merely the effect of an inflated currency in other countries — will reduce the power of American exporters to sell their goods abroad. But when a nation has come to rely upon foreign markets for the sale of a part of her product, a loss or diminution of her power to export cannot occur without shock to her industrial structure. In the United States, an important part of the cotton and cereal crops — known as the *export surplus* — must find outlet abroad if the price of these commodities is not to break to levels so low as to cause loss to the planters and farmers. Moreover, the producers of these great crops constitute the largest group of buyers within the nation of the products of domestic manufactures; when they stop or curtail their buying, a depressing effect upon the industry of the entire country is immediately felt. This interdependence between the producing groups of the country makes any sudden loss of foreign markets for our staple crops a national calamity, whose ultimate effects are depression in the domestic market, loss of profit to manufacturers, and unemployment to workingmen.

That a nation is injured by a situation which causes its exchange to sell at too high a price in foreign markets may be seen, also, from another point of view. Granting that the prevailing antagonism against imported goods is based upon unsound reasoning, and that a nation gains from an unrestricted import trade, it remains true, nevertheless, that floods of imports artificially induced at irregular intervals by a breakdown of the exchange market is disruptive of the domestic market. A bounty on imports is at least as vicious

in its economic effects as is a protective tariff which burdens imports with restrictive taxes. A premium on a nation's bills in foreign markets acts, as we have seen, as a bounty on imports. The experience of the United States with this situation following the Great War has proved without doubt that too great a premium on dollar bills can be anything but "favorable" to the business of the country. Meeting competition from foreign producers whose goods were artificially cheapened in the American market by the condition of the exchanges, the manufacturers within the country have frequently asserted their inability to continue operations and have appealed for aid to the Federal Government. In many other countries, as well as our own, special tariff legislation — "anti-dumping" taxes, and so forth — has been projected as a protection against that condition of the exchange market which is customarily called "favorable to the nation."

The truth is that one country gains from the prosperity, not the adversity, of another. Any calamity which destroys one nation's productivity, impoverishes her people, and curtails her power to buy the products of other nations, immediately upsets the balance of international commerce, and sooner or later, makes its effects felt in all the exchange markets of the world. Individuals in other countries may seize the opportunity to take for themselves the markets which producers in the nation suffering misfortune have been compelled to relinquish; to them the calamity which has destroyed their competitors may seem an unmixed blessing, but their gains will be more than offset by the general handicap to commerce which their country shares in common with all others. Unbalanced trade cannot persist for any length of time without providing its own corrective in the form of burdensome rates of exchange. In a normal market, occasional shifts in the balance of payment will be offset by an outflow of gold, or an inflow, as the case may be; but when the unbalanced state of commerce is caused by a factor of fundamental and far-reaching importance — as, for example, by the prostration of Europe following the Great War —

these normal correctives fail of their effect, and the rates of exchange will so influence the imports and exports of the country as ultimately to restore the balance in its foreign commerce.

33. **The embargo on gold.** Nations are sometimes tempted to prohibit the exportation of gold when the balance of trade is against them. This policy has some justification in times of unusual credit stringency when there is imminent danger that the banks or the Government may be forced to suspend specie payment through a lack of adequate gold reserves; but the widespread fallacies, so prevalent and so deeply rooted in the common mind, concerning the relation of the gold stock to the wealth of the nation, cause an urging of this policy upon the Government when no such justification exists. Thus, when the embargo on gold was lifted in the United States in June of the year 1919, there was much outcry against the decision of the Government to interfere no longer in the free movement of the precious metal from our country. At that time the foreign trade of the United States was in a peculiarly distorted condition; exports vastly outweighed imports in the total trade statement, but our favorable balance was practically limited to our commerce with Europe, while imports preponderated in our trade with the rest of the world, and especially with the Far East. Europe was unable to send gold in any quantity in payment of her balance owing here, whereas our decision to permit gold exportation immediately set in motion a current of specie toward Japan and China. This loss of gold appeared to many people to be detrimental to the economic welfare of the country and attempts were made to reinstitute the embargo. In such a situation as this, it should be clear that any unnecessary interference with the functioning of the exchange market must react to the injury of the country as a whole.

It is not necessary to consider at length all the reasons why interference with the free movement of gold between the nations is unwise. It is, for example, beneficial to the credit of a nation to acquire an international reputation for prompt and willing payment of all obligations on demand. London's

position of supremacy among the exchange markets of the world, a position which has reacted favorably upon British traders by increasing the ease with which they have financed their transactions and improving the credit terms accorded them by foreign sellers, has rested in part upon her long history as a free gold market. No other city can attain a similar preëminence as long as a chance remains that specie payment of foreign obligations will be stopped without compelling cause. Whatever economic advantage the business men of the United States might gain from an extension of the use of dollar credits, and the position of New York as an international money center, can be lost through any injury to our credit caused by arbitrary governmental interference in the movement of gold. Disregarding these considerations, however, there remain other, and more fundamental, reasons why an embargo on gold should not be adopted except as a last resort. We shall consider two of these reasons.

In the first place, when the exchange rates have risen to the gold exporting point, the shipment of gold has become the *cheapest* form of payment available to the nation. We may repeat that the rates will rise to this premium only when the nation is in debt on the current balance of trade and must make payment to foreign creditors in one form or another. To prevent gold from leaving the country under these conditions will remove the check upon the rising rates, permitting the premium to go to abnormal lengths, until a gradual and more or less painful readjustment of exports and imports brings commerce into equilibrium. While this process is under way, the entire import trade of the nation will be taxed by the burdensome premium charge, and the nation as a whole will bear a heavy cost as a consequence of its own refusal to discharge its obligations in specie. In comparison with this widespread burden, the shipment of gold affords a much more economical method of payment.

In explanation, let us assume that the sterling sight rate has risen to a position slightly above the specie point and that gold has begun to leave the country. From the standpoint of the bankers who supply the market with sterling demand

drafts, there can be no doubt that it is now cheaper to make payments to London in gold rather than in bills of exchange; in fact, the specie point on sterling exchange is determined by this very comparison of the relative costs of the two modes of payment, being set at the quotation at which gold shipments become the cheaper. A prohibition of gold shipment will force all debtors to England to adopt the dearer method of payment, and, as their competition drives the sterling rates above the specie point, the cost involved in the employment of this more expensive means of payment will grow continually heavier. All importers of English goods, therefore, will be penalized when buying drafts to pay debts previously contracted. But the evil will spread further until a similar burden is placed upon importers trading with other countries than England. Normally, as has been shown in another place,¹ the exchange rates of all countries are brought into harmony with each other through the equalizing effects of arbitrage. The premium on sterling exchange, if prolonged and increased by a gold embargo, will react upon the other rates, causing them, also, to rise with the result that all importers are penalized when buying sight drafts to pay debts already contracted. Bills of exchange are, on the whole, a most economical and cost-saving device; but they are not always cheaper than other modes of payment, and to force their use upon a country when they have ceased to be less expensive than the shipping of gold is tantamount to taxing, *ex post facto*, all individuals within the country who have contracted foreign obligations.

In the second place, free movement of gold between the nations is a normal and healthful method of bringing international commerce into equilibrium. The exchange rates would not rise to the specie point if the nation paid in goods and services, or gave satisfactory promises to pay at a later date, for the things she buys of other peoples. Only when the nation buys more than she pays for, and gives no acceptable promises to pay the balance, will she be called upon to export gold. But this is not a healthful condition and it cannot con-

¹ See pages 97 f.

tinue; its correction demands that the nation reduce its purchases within the measure of its ability to pay, and the free movement of gold will work out this correction by a natural and painless process.

Goods are imported only when their prices are so much lower abroad that they can bear the cost of transportation and still compete with domestic goods in the importing market. If a country is importing more than it should — that is, more than it can make payment for — the most effective solution is to remove the incentive to import by diminishing the discrepancy between foreign and domestic prices. One basic factor determining the general price levels of the different countries is their supply of primary money — that is, for gold standard countries, the stock of gold bullion and coin. As the stock of gold increases, credit expands and the general price level rises; as the stock of gold decreases, credit contracts and the price level falls. Hence, when gold is shipped from one nation to another in considerable quantities, the average of prices in the former will begin to fall; in the latter, to rise. As a consequence, individuals within the country which is losing gold will gradually lose their incentive to import, as domestic prices cease to be higher than foreign prices. This process will, of course, not affect all goods in the same degree, nor will it work out its effect suddenly or in a manner to subject the industrial structures of the nations concerned to an arbitrary disturbance. But its effects will be far-reaching, and they will be permanent until some new factor enters to disturb again the equilibrium of trade; whereas if gold is prevented from leaving the country when the balance of trade is unfavorable, and the consequent rise of the rates of exchange brings about a reduction of imports by reason of its burden upon the import trade, the situation will remain distorted, since the price levels of the two countries will not have been brought into adjustment with each other.

This effect of the gold movement upon the relative price levels of the nations makes it clear that much of the opposition to the exportation of gold is unfounded. The fear that

the monetary stock of the country will be completely exhausted, or even seriously impaired, when the balance of trade is unfavorable, has no basis in fact; for the outflow of gold is self-limiting. It cannot continue longer than its cause — the discrepancy between foreign and domestic prices which induces an excessive importation of foreign goods; by removing the cause of the unbalanced trade, the outflow of gold brings itself to an end without the interference of governments, and this natural limit to the loss of gold will be reached before the country can suffer any ill-effects from the lessening of its money supply. These statements are made, of course, only with reference to normal conditions; in times of war or financial panic, the conserving of the gold stock may be an unavoidable necessity regardless of the detrimental effects of the policy.

34. Pegging the rate of exchange. Occasions may arise when a country is unwilling or unable either to export gold or to reduce its importations of foreign goods, although its bills are quoted at low rates in foreign markets. This has been the condition of certain European countries with respect to their trade with the United States following the Great War. Burdened with heavy exchange charges when making payment for American goods, the importers in these countries have, in numerous instances, found it impossible to continue their business; national interest, on the other hand, has demanded that the trade be kept alive at all costs, since there was no other market from which supplies of essential materials could be obtained. In view of this state of national necessity and of the absence of the normal correctives of the exchange market, it has been proposed to stabilize the exchange rates in New York by artificial means, fixing a definite point below which they will not be allowed to fall. This arbitrary limitation on the fluctuations of the exchange market is called *pegging* the rates of exchange.

Before proceeding to examine the method and effects of pegging the rates, it may be well to call attention to the fact that the motive behind the policy is largely drawn from a misconception of the forces which govern the exchange

markets. When the rates of exchange on a nation's bills are unfavorable, the belief spreads that foreign bankers and business men have deliberately manipulated the exchange market with the intention of reaping exorbitant profits from the necessities of the importing country. This view is, of course, totally without foundation in fact. Abnormally low rates on foreign bills in New York, for example, are not a source of profit, but a burden and a handicap to the business men and bankers of the United States. Moreover, these quotations are caused, not by the business interests of this country, but by the action of foreign importers whose competition for credits in New York causes the dollar rates to rise to excessive premiums abroad and the foreign rates to fall to excessive discounts here. No country is benefited by an abnormal condition of the exchange market. However, the common belief that they are being exploited when exchange rates are unfavorable frequently impels the people of a country to adopt artificial means of removing the handicap to their trade.

The attempt to peg the rate of exchange relies for its effectiveness upon providing an offset for the force which is causing the rate to fall. This force is an excessive supply of bills drawn against the country and offered for sale by foreign exporters; the rate can be prevented from falling only by creating a large enough demand for these bills to absorb the entire supply at a given rate. For example, when the sterling rate was pegged in New York during the final years of the Great War, England undertook to buy all sterling bills offered for sale in New York at a uniform price of 4.76. The unlimited demand for sterling at that rate prevented the purchase of sterling bills on lower terms by any other agency in New York, since the holders of these bills would not knowingly dispose of them for less than the highest available price. The device did not, of itself, prevent the rate from rising above 4.76; but the supply of bills drawn on England was so great during this period, and the demand from the commercial world so small, that there was no impulse to raise the rate above this minimum. While the policy was in

operation, therefore, sterling remained at a fixed quotation, and British importers were relieved from the burden of an extreme discount on sterling bills which would undoubtedly have developed if the market had been subjected to the free play of competitive forces.

The policy of pegging the rate of exchange relies upon a demand for bills which is abnormal in the sense that it does not arise from international commerce, but must be created for the express purpose of absorbing the supply of bills having a commercial origin. To create the funds with which to buy these bills, an indefinite credit must first be established within the market where the exchange rate is to be pegged. The British Government created this credit by borrowing from the Treasury of the United States, placing the funds obtained in this manner in the hands of bankers in New York to be used for the purchase of sterling bills. Any attempt to peg the rate of exchange must proceed upon similar lines; essentially, the process consists in inducing one group of citizens within the country (the group which lends the funds used to peg the rate) to pay a second group of citizens for goods supplied to a foreign people, on the promise of a return of the funds thus advanced at a later date. The policy will be effective in stabilizing the rate of exchange so long as a sufficient amount of funds can be borrowed *within the market itself* to absorb all bills offered for sale there. There are weighty reasons why such an interference with the exchange market is undesirable and injurious.

At best the attempt to prevent the rate from falling can be effective only as a temporary policy. Eventually, the funds borrowed by the nation for the purpose of buying its own bills of exchange must be repaid with interest; for it is inconceivable that any group of people will continue indefinitely to supply goods to a foreign country and bear their cost themselves. If the loans are refunded as they fall due, and new loans are contracted to continue the policy, this will only postpone the time of repayment and increase the amount to be paid; eventually the sheer impossibility of obtaining credit within the market for this purpose must bring the policy to

an end. But when the repayment of the loans commences, the force depressing the rate of exchange will be increased in magnitude; for the repayment of a loan by one country to another creates in the creditor market a supply of bills drawn on the debtor. This supply of bills will be added to the supply drawn by the exporters of goods and so will increase the pressure on the rate of exchange. If the original cause — that is, an unbalanced commerce — is still operative, the policy of pegging the rate will only have made matters worse; for now the excess supply of bills will be larger than ever and the rate must fall still farther to take them off the market. Only in the event that the balance of payment has shifted in the meantime, and the country which has been buying its own bills now finds that the commercial demand is large enough to absorb the supply, can the device fail to aggravate the evil which it aims to correct.

This brings us to a second, and more serious, objection to the device of pegging the rate of exchange: the policy exerts an influence upon international trade which tends to perpetuate a distorted and unbalanced state of commerce. If sterling, or other foreign rates are falling in the New York market, the only permanent solution of the problem is for the countries in question to diminish their imports of American goods and increase their exports to America. But to maintain the rates at a high point removes all penalty on the importation of goods from the United States, and all encouragement to increase exports to this country. Hence, the unbalanced state of commerce is likely to continue or even to grow more extreme; industries both here and abroad will become adjusted to the existing volume of exports and imports, so that when the policy of pegging the rates ends — and end it must from sheer impossibility of continuing it indefinitely — the resulting collapse of the exchange market will be at the same time more extreme and more disastrous in its effects than if the readjustment had proceeded gradually under the pressure of a slowly falling rate of exchange.

CHAPTER VI

BANKERS' BILLS OF EXCHANGE

35. Bankers' demand drafts and cables. Generally speaking, international transactions are liquidated in either of two ways: by a bill of exchange drawn by the creditor; or by a remittance of a bill of exchange by the debtor. In the chapters immediately following, we shall examine the different forms of bills which arise from international commercial transactions when the creditor draws; it is our present purpose to discuss the practice of the exchange markets in those cases where the terms of sale place upon the buyer the obligation of remitting payment to the seller. Such terms, though common in the dealings of American exporters with certain markets, have been, on the whole, the exception to the rule in international trade. They result, for the most part, from cash sales — that is, sales which require cash payment from the buyer either in advance of, or upon, delivery of the goods — or from sales on open book account, where the buyer is instructed to cancel his debt at the end of a predetermined period by a remittance of cash. As used in foreign trade, cash terms do not, of course, signify the remittance of gold or other money, but rather the remittance of an instrument which can be turned into money without delay by the creditor. The instrument used for this purpose is most commonly the bankers' demand draft, or check; though in rare cases, when time must be saved, the cable is employed.

The demand draft and the cable (often called the *telegraphic transfer*) have been described at various points in the preceding pages; our present purpose will be to gather this information together, and to illustrate the practical use made of these instruments by the business world. Let us assume, then, that an importer of American goods in Argentina is under the necessity of sending one thousand dollars in cash

to his creditor in New York in payment of an account falling due on the creditor's books. The importer will go to his banker and buy for pesos a demand draft for this amount drawn on a banker in New York, payable to himself, or his order. Properly endorsed, this draft will be sent by mail to the exporter in America, who will deposit it at his bank; it will be presented to the drawee-banker for payment, and, a few hours after its arrival, the exporter's bank account will have been increased by the amount of the draft. From the point of view of the exporter, this mode of payment is no less convenient than the receipt of checks from his domestic customers; for the importer, it is more convenient than the shipment of gold, or other money; both business men deal with their own bankers and in their own currency. To create and maintain the balance in New York which allows the South American banker to draw a demand draft payable in that city in dollars requires that the drawing banker remit to his New York correspondent a stream of collection and discount items — bills of exchange of various kinds — which will cause an inflow of funds to the correspondent banker. This two-sided transaction, the buying of miscellaneous bills from his clients payable in foreign centers, and the sale of his own demand drafts against his foreign credits, constitutes the principal business of the exchange banker.

The cable, or telegraphic transfer, is a demand draft sent by cable instead of by mail. Its effect upon the banker's foreign balance is more immediate and this difference causes a variation in the rates at which the banker will sell the two forms of exchange.¹ The cable is used in international commerce for transmitting funds when the saving of time is a significant factor in the profitableness of the transaction. In business transactions, its chief service consists in enabling the debtor to postpone his remittance for a number of days and, thereby, to extend the credit period within which he is allowed to prepare for payment.

To illustrate with reference to the example employed above,

¹ See pages 84 f., where the relation of the cable to the sight rate is explained.

let us assume that the Argentine importer is under obligation to place his remittance in the hands of the New York exporter on July 1st. The mail time between Buenos Aires and New York we may suppose to be thirty days; hence, to discharge his obligation by remitting a demand draft, the Argentine merchant must expend his pesos in the purchase of the draft on June 1st. But by using the cable, he can postpone remittance until two days before his creditor must receive his money, thus obtaining an extension of credit for twenty-eight days. The telegraphic transfer will cost more than the demand draft, of course, and the service charge for using the cable will add still another item to the importer's expense. Nevertheless, conditions in the importer's market may be such as to make this additional cost worth while. He may not have been able to dispose of the goods which he has imported, but expects a better market in a short time; or, he may be pressed for funds and finds it cheaper to gain twenty-eight days' extension at the cost of using the cable than to borrow from his bank; or, the rates of exchange may be adverse on June 1st and he expects rates to be sufficiently lower later on to make postponement worth while. The cable is more frequently used to postpone payment in international transactions other than commercial. Bankers who have borrowed in a foreign market may find, as the date for repayment approaches, that their funds are so well employed as to make it worth while to gain a few days by remitting cable transfers instead of checks. Speculators who have sold long exchange, expecting to cover later at lower rates, may use the cable to postpone payment for a few days when rates are falling. These transactions between the bankers of different exchange centers will be explained at greater length at a later point in our study.

Further information concerning the bank's methods of handling demand drafts and telegraphic transfers may be obtained by examining the copies given on pages 134-35, of the forms used by the largest New York bank when selling these bills to their clients.

The first of these, an order for a cable transfer by the client

of the bank, shows that in the case of this type of exchange it is the bank which actually makes the remittance, and not the buyer of the cable. The latter fills out the blank, giving the name of the foreign drawee and the amount to be sent stated in the foreign currency; this amount is turned into dollars at the cable rate of exchange, the cost of sending the message over the wire is then added, and the total is paid by the client of the bank. The bank then undertakes to transmit the message in the form of the telegram to the drawee, giving him an order drawn payable on demand upon the bank's correspondent. The banker's demand draft, as shown by the second form, is filled out by some one in the foreign department of the bank, signed by the appropriate officer and delivered to the client to be sent by mail to the foreign drawee.

Attention is called to the inserted paragraphs which these forms contain. The first of these paragraphs, which appears upon the order for a cable transfer, shows that the bank, while accepting payment from the client in advance, specifically waives all liability for errors or failure to transmit on the part of the cable company; all such risks are to be borne by the bank's client. The second paragraph, which also appears in substantially the same form upon the application for a banker's draft, contains information of some importance to the client. This paragraph, in the first place, emphasizes the fact that the bank's rule when dealing in foreign exchange is one of *compensating purchase and sale*; that is, "exchange will be promptly purchased to cover this remittance." Because of this practice, the bank refuses to be held liable, in case payment is not made abroad, "for any amount in excess of the value in New York of such exchange at the time refund is made." In other words, the client is not to expect a refund of the amount of money paid by him when the bill was purchased, but of the value at that time of the cover bought by the bank; hence, the refund may be less than the amount paid by the client. The effect of this clause is obviously to throw upon the client, not only the risk of inconvenience due to failure of payment abroad, but also risk of loss through decline in the rates of exchange in the period

FORM 4. ORDER FOR CABLE TRANSFER

ORDER FOR CABLE TRANSFER

THE NATIONAL CITY BANK OF NEW YORK

FOREIGN DIVISION

55 WALL STREET, NEW YORK

New York.....19.....

Please transfer by cable to.....

Address.....

On account of.....

Amount..... Rate..... \$.....

THE NATIONAL CITY BANK OF NEW YORK WILL NOT BE RESPONSIBLE FOR
MUTILATIONS, INTERRUPTIONS, ERRORS, OR DELAYS ON THE PART OF ANY TEL-
EGRAPH OR CABLE COMPANY, OR ON THE PART OF ANY OPERATOR.

AS EXCHANGE WILL BE PROMPTLY PURCHASED TO COVER THIS REMITTANCE,
THE NATIONAL CITY BANK OF NEW YORK WILL NOT BE LIABLE, IN THE EVENT
THAT PAYMENT FOR ANY REASON CANNOT BE MADE, FOR ANY AMOUNT IN EX-
CESS OF THE VALUE IN NEW YORK OF SUCH EXCHANGE AT THE TIME REFUND
IS ASKED. FUNDS ARE ACCEPTED ONLY UPON THESE CONDITIONS.

Cost of Message.....

Total.....

Purchaser..... Address.....

Payment {
effected
through {

APPROVED FOR FILES	RECEIVED PAYMENT AMOUNT HELD	TICKETS	CHECKED	AUDITED	NUMBER

FORM 5. APPLICATION FOR FOREIGN EXCHANGE
THE NATIONAL CITY BANK OF NEW YORK
FOREIGN TELLERS
55 WALL STREET, NEW YORK

ORDER NUMBER

APPLICATION FOR FOREIGN EXCHANGE

TERMS: CASH OR CERTIFIED CHECK **NEW YORK,** **192..**

Please issue On
 (Draft or Letter Payment) (City)
For **Rate** **\$**
 Foreign Currency

Draft or L/P Issued	Advices and Entries Checked	Converted By	Conversion By	Amount Held	Approved for Filing

In favor of

It is understood that exchange will be promptly purchased to cover this remittance and that The National City Bank of New York will therefore not be liable, in the event that payment for any reason cannot be made, for any amount in excess of the value in New York of such exchange at the time refund is asked. Funds are accepted only upon that condition.

Name of Applicant
Address

which elapses between the purchase of the bill and the refund by the bank. From the standpoint of the bank, this practice is defended by the following reasoning: the bank has bought

FORM 6. BANKER'S STERLING DEMAND DRAFT

Foreign drafts of all kinds are invariably drawn in duplicate or triplicate. The "original" is sent by one mail, and the "duplicate" by the following mail, to guard against the risk of loss in transit. The third copy, if drawn, is retained as a record of the transaction.

Guaranty Trust Company of New York	\$5,000+ <i>Ag New York, February 24th 1919.</i>	<i>Pay John Johnson & Co</i> <i>or order (Duplicate being retained) the sum of</i> <i>Five thousand pounds to the order of</i> <i>which charge to New York account</i>	DRAWN	PER PRO PER PRO	ASSISTANT SECRETARY ASSISTANT MANAGER
	No 74956	Guaranty Trust Company of New York, 32 Lombard Street, London.			

Guaranty Trust Company of New York	\$5,000+ <i>Ag New York, February 24th 1919.</i>	<i>Pay John Johnson & Co</i> <i>or order (Duplicate being retained) the sum of</i> <i>Five thousand pounds to the order of</i> <i>which charge to New York account</i>	DRAWN	PER PRO PER PRO	ASSISTANT SECRETARY ASSISTANT MANAGER
	No 74956	Guaranty Trust Company of New York, 32 Lombard Street, London.			

cover for a remittance made for the benefit of the client; in case payment abroad is not made, this cover will remain with the foreign correspondent where it will have a value deter-

mined by the rate of exchange; thus, if a refund is made, the bank should not be made to lose because of shrinkage in the value of the cover.¹

Bankers' demand drafts command the widest and most competitive market of all forms of exchange, and their prices respond most readily to the fluctuations of demand and supply. Not only are these drafts bought by business men for payments due to foreign creditors, but bankers and other exchange dealers regularly buy and sell them among themselves. Each banker keeps close watch upon his foreign balance, striving to maintain a sufficient credit to meet all the drafts he might wish to make, and, at the same time, to avoid loss due to idle funds in a foreign city. This proportioning of the size of his foreign balance to the uses to which it can be put is accomplished by maintaining a rough equality from day to day between the debits and credits to his account with the foreign correspondent, so that a stable average credit may be available at all times. But if governed only by his relations with his clients, the accretions to the banker's foreign balance, and the debits against it, can scarcely be uniform from day to day; for the bills he buys for remittance will vary in length of life and in amount according to the nature of his clients' transactions, and the demand for his own checks and cables will fluctuate with the needs of the business world. To offset these variations, the banker will buy demand drafts in the open market when his foreign balance must be replenished, and offer his own drafts for sale when the credit has grown to undue proportions. When engaged in this manner in offsetting his transactions with business men by operations in the open market, it is obvious that the terms offered by the banker to his customers will be conditioned upon the rates which he himself must give or take in the open market. That is, the banker's buying price for commercial bills will be derived from the open market sight rate of exchange; his profit will be drawn from a slight difference in his favor between the rates of exchange at which he buys and sells.

¹ This practice has developed because of unsettled conditions which have followed the Great War; it may not be permanent.

Without raising again the problem of the rates of exchange, it may be in point at this place to note that the same forces which cause the balance of an individual banker to swell beyond the point of profit, will, at the same time, in all probability, operate in the same way upon other exchange bankers of his market. For the offerings of commercial bills to the banks in New York are controlled fundamentally by the volume of exports from this country to foreign markets, and are, therefore, subject to the seasonal ebb and flow of our commerce. So it comes about that many bankers are at the same time anxious to sell their demand drafts in the open market, while few are in a position to buy them profitably, and competition among the sellers depresses the rate of exchange toward the specie importing point. On the other hand, the demand for drafts with which to pay for our imports will probably exhaust the foreign credits of many bankers at the same time, forcing them into the market as buyers of bills of exchange, and thus driving the rates upward toward the specie exporting point. For these reasons, the open market quotation on *bankers' demand drafts* is a sensitive index to the total demand and supply of bills of exchange, and, more fundamentally, to the ebb and flow of international commerce.

This matter of the fluctuations in the rates of exchange raises the question as to the effect of these fluctuations upon the profits of business men whose undertakings require them to make or receive remittances of foreign demand drafts. Returning to our illustration from the typical transaction between a New York and an Argentine merchant, we call attention to the fact that the Argentine importer was compelled to bear the cost of changing one kind of money into another; that is to say, it fell to his lot to expend pesos in the purchase of a dollar demand draft. The American exporter, who had sold goods worth \$1000, received his payment in dollars; for *him*, the transaction was in no wise affected by the position of the rate of exchange between New York and Argentina. But this matter of the rate of exchange was of some importance to the importer, since it had the power to affect the profitableness of the transaction. At par, the dollar draft

for \$1000 would cost him 2356 pesos (par between Argentina and New York is \$42.44 = 100 pesos). If, however, he had bought the draft on March 11, 1921, when the dollar commanded a premium of 18.4 per cent in Argentina, its cost would have been 2789.50 pesos; three months later, on June 10th, the same draft would have cost 2975.62 pesos, because the premium on the dollar had in the meantime risen to 26.3 per cent. Now, the Argentine importer, obviously, cannot know how much he has paid for the goods until the dollar draft has been bought, nor can he safely price them for sale in his own market until he knows what they have cost. Consulting the exchange rate on the day the goods arrive will not avail to solve his problem, if the rate is subject to sudden and violent fluctuations such as that illustrated in the two quotations given above for March 11th and June 10th, 1921, respectively. This danger of loss through adverse changes in the rates is called *risk of exchange*. It is borne by all merchants whose costs or receipts are conditioned upon the position of a rate of exchange upon some future date, after they have made commitments in international transactions.

From what has just been said concerning the risk of exchange, it will be readily understood that importers who obligate themselves to make future remittances of demand drafts are concerned that the type of draft agreed upon shall be one whose rate of exchange is relatively stable. The example given above is, of course, abnormal, since it was chosen from a time when the foreign exchange markets of the world were greatly disturbed by post-war conditions. But even in normal times these fluctuations in the sight rates occur, and their violence varies greatly among bills drawn in different moneys. As explained in another place,¹ these changes in the banker's drawing rate for demand drafts on foreign cities are caused by changes in the condition of the banker's balance in those cities in relation to the demands made upon him to draw against these balances. They are least likely to occur with respect to demand drafts drawn on foreign centers where the banker's foreign balance is maintained in a relatively

¹ See pages 61 f.

stable condition because of the fact that, in his own market, there is a broad and continuous demand for his drafts and an equally broad and continuous supply of the bills of his clients payable in that city. They are most likely to occur with respect to demand drafts drawn on out-of-the-way places where the banker's balance fluctuates widely because the debits and credits which he makes to it are discontinuous and erratic. Business men engaged in foreign trade learn from experience what kinds of bills are most easily procured and command the most stable rates of exchange, and, by common consent, they employ these bills much more widely than any others. It is for this reason among others that sterling drafts have been used in the past in preference to dollar drafts, even to discharge remittances to the United States; though the broader market for dollar bills which has developed in most foreign centers since the Great War is somewhat qualifying the older practice. We need not stress the fact that when the remittance draft is drawn in a third money — foreign to both importer and exporter — as in remittances of sterling sight drafts from South America to the United States — both parties must bear a risk of exchange, since the costs of the importer and the receipts of the exporter are both dependent upon the position of the sterling sight rate in their markets at a future date.

Thus far in our discussion, it has been assumed that demand drafts and cables are drawn against foreign balances maintained by the drawing bankers with their correspondents. But if the maintenance of a foreign balance were the sole condition upon which these drafts could be drawn, very few bankers in any country could supply them to their clients, since the majority of bankers — especially those at inland points — never carry a foreign balance. Moreover, even those larger banking houses which engage actively in the business of foreign exchange would frequently be unable to draw drafts at the request of their clients, since they cannot attempt to carry balances in every one of the foreign centers in which business men might have need of funds. Yet we know that inland bankers who have no foreign balances do

draw demand drafts in favor of the business men in their markets, and that exchange bankers at the seaboard are rarely at a loss to provide these drafts no matter where they are payable. We shall now consider the means customarily employed to enable a banker to draw against a foreign bank with which the drawing banker carries no balance.

With regard to the inland banks, the procedure is somewhat as follows: The large banks in New York offer a service to these inland banks, the purpose of which is to enable the inland bankers to draw checks against any of the foreign balances of the New York banker. The conditions on which the service is offered are that the inland bank maintain a deposit with the New York bank proportioned to the average amount of the inland bank's drawings, and agree to a certain schedule of commission charges. The drafts are drawn on a form of a peculiar kind — peculiar in color, shape, or wording — supplied by the New York bank; this distinctive appearance serves to identify the drafts to the foreign correspondents of the New York bank, who, of course, are apprised in advance of the permission extended the inland bank to draw against another banker's balance. They are paid by the foreign correspondent out of the New York bank's balance, and the latter recoups itself by charging the appropriate amount against the deposit which the inland bank maintains in New York.

A typical transaction liquidated by this method would be carried through as follows: Suppose a dealer in china-ware situated in Des Moines, Iowa, is under obligation to remit to England a demand draft for one thousand pounds sterling in payment for goods imported. His banker in Des Moines, though he carries no balance in London, has engaged the services of a New York banker who does have a London balance, carrying the requisite deposit with the New York banker for this purpose. The china-ware merchant requests a sterling demand draft of one thousand pounds; the Des Moines banker draws it directly against a London bank on the appropriate form, gives it to the merchant, and informs the New York bank of the transaction. The New York banker immediately sends advice to London sanctioning the draft and

requesting that it be paid out of his balance. By the time the draft, which has been mailed by the merchant to his English creditor, reaches London, the banker there will have authority to pay it. For the Des Moines banker, the transaction is cleared up by a charge of one thousand pounds at the current sight rate made by the New York bank against his deposit; the relations of the New York bank to the London correspondent are, of course, affected by this transaction precisely as if the draft had been drawn by the New York banker, himself. For the use of inland bankers who are their regular clients in transactions of this kind, the New York banks publish daily schedules of their drawing rates on the principal foreign centers. With this information in hand, the inland banker, by adding the commission charge he is obliged to pay in New York, may pass on the total charge of the transaction to the buyer of the demand draft in the form of a rate of exchange.

Certain variations of the process just described are to be found. The drawing inland banker may not keep a permanent deposit in New York, but may remit cover for each draft drawn (plus the New York banker's commission) at the time of drawing, employing domestic exchange for this purpose. A less convenient method than either of these, and one employed only by inland bankers whose dealings in foreign exchange are very rare, consists in receiving the client's money together with a memorandum of the proposed transaction (the amount of the bill, name of the foreign drawee, etc.) and sending it along to a New York bank with a request that the prescribed draft be drawn and mailed. The delay involved in this roundabout procedure prevents its use by business men whose need for foreign exchange is at all regular.

Various methods are employed by the foreign exchange bankers in the larger cities to enable them to draw drafts upon places where they maintain no deposit. There are certain cities, of course, in which all exchange bankers the world over carry balances; one such city is London, another Paris, etc. These central, or pivotal, points are made clearing houses for the debits and credits of exchange bankers who wish to draw on each other without keeping deposits with each other. If,

for example, two of these dealers, situated in different parts of the world, have balances with the same bank in London, one may draw on the other, requesting the latter to recover by drawing on the London bank. Assume that the First Commercial Bank of New York and the Imperial Ottoman Bank of Constantinople are both correspondents of the London Exchange Bank, but that neither carries a balance with the other. A request comes to the First Commercial Bank to draw a demand draft payable in Turkish pounds. The First Commercial Bank draws this draft upon the Imperial Ottoman Bank, requests the latter to honor it and reimburse itself by drawing the requisite amount of sterling upon the London Exchange Bank. The First Commercial Bank then sends advice to the London Exchange Bank, instructing it to pay the sterling demand draft drawn in Constantinople out of the Commercial Bank's balance. So far as the bankers are concerned, this transaction has the following effects: the drawing banker in New York receives money from the buyer of the demand draft on Constantinople and suffers an equivalent loss from his London balance; the drawee-banker in Constantinople expends money to honor this draft, but acquires a like sum by selling, at once, a sterling demand draft; the London banker merely debits the account kept by the New York banker with him. The cost to the New York banker of supplying this demand draft on Constantinople will be equal, of course, to the value in New York of the amount subtracted from his London balance at a later date. How much this subtraction will be depends upon the sterling sight rate in Constantinople on the day when the Imperial Ottoman Bank honors the New York banker's demand draft; what this rate will be cannot be known in New York when the Turkish draft is drawn. Hence, the New York banker takes a risk of exchange against which he provides by loading the price he asks for the Turkish demand draft.

The large exchange bankers in the principal world centers hold balances for a great number of bankers in different parts of the world; this gives them the opportunity of drawing against these correspondents without carrying deposits in all

the foreign cities represented. A New York bank, for example, may hold a balance from a bank in Constantinople, but carry no balance with this correspondent. It may, however, draw on the Constantinople bank, request this bank to honor the draft, and offer reimbursement by crediting the drawee-banker's balance in New York. Or, the Constantinople bank may reimburse itself by drawing a dollar demand draft on New York for the necessary amount, which draft the New York banker will pay without subtraction from the balance carried by the bank in Constantinople. By methods such as these, the larger banks dealing in foreign exchange are enabled to draw demand drafts on most of the markets of the world without maintaining balances in all of these markets. These dealings are, of course, much less numerous and more irregular than those which involve centers more closely united, and their costs to the buyers of the drafts are higher.

36. Bankers' long bills. Long bills drawn by bankers are similar to demand drafts in that they bear the names of bankers as drawer and drawee and, so far as appearance goes, dissimilar only in that a fixed interval of time must elapse after acceptance before the drawee can be called upon for payment. This formal distinction, however, leads to differences in the handling of bankers' long bills which are of great significance. When a demand draft, drawn by an American banker upon an English correspondent, is presented for payment, a charge is at once made against the balance of the drawing banker. The drawer is, accordingly, compelled to supply cover for his demand drafts either in advance of, or at the same time as, his sale of them. A long bill, on the other hand, when presented to the drawee-bank, is not paid, but accepted, and is charged against the drawer's acceptance account. Although it becomes the legal obligation of the acceptor, not greatly differing from his promissory note, the agreement between the two bankers will provide that the drawer place funds in the hands of the acceptor in sufficient time to meet the obligation when it matures. It is obvious that this cover need not be bought until some days after the drawing and sale of the bill, an interval roughly equal to the

number of days stated on the bill's face. Thus, the drawer of a bankers' long bill obtains an advance of funds on the strength of his agreement to repay at a later date, and this feature of the transaction makes of this type of bill a convenient instrument by means of which bankers in one money center borrow the current funds of a foreign city upon the strength of the acceptances of local bankers.

Furthermore, the translation of the long bill into the acceptance of the drawee-banker, gives the holder of the bill a negotiable instrument which may readily be sold in the discount market. If the holder retains it until maturity, he must view it in the light of an investment for the life of the bill; if he discounts it in the money market, the next buyer must view it in that light. Bankers' long bills of exchange are, therefore, much affected by the state of the money market, by the supply of funds available for short-term investment, and the rate of discount which obtains at the time of drawing. These aspects of the bankers' long bill will be elaborated in the following pages; before proceeding, however, it may be well to illustrate the principal features of this type of foreign bill of exchange by means of a typical series of transactions.

Assume, then, that a New York banker draws on his London correspondent at sixty days' sight for eight thousand pounds sterling and sells the bill at its present value in dollars and cents to some one in New York. The buyer of this bill will have supplied himself with an instrument which will be worth eight thousand pounds sterling sixty days after its acceptance in London. He will forward it to some one in England who will present it for acceptance and sell it in the discount market, or hold it until maturity. Before the bill is payable, the drawing banker will have supplied the London acceptor with funds for its redemption. The supplying of this cover may be done in such a way as either to close out the credit relationship created between the two bankers by the drawing of the long bill, or to extend this relationship over another period. If the former of these alternatives is adopted, the New York banker will buy demand drafts worth eight thousand pounds in the open market and send them to his

London correspondent for encashment, the proceeds being used to take up the long bill. Or, if it is desired to postpone the remittance until the last moment, he will buy a cable

FORM 7. BANKER'S STERLING LONG BILL

<p style="text-align: center;">Guaranty Trust Company of New York</p> <p><i>L. 1000 \$</i> NEW YORK <i>February 24th</i> 1909</p> <p><i>Sixty</i> DAYS AFTER SIGHT OF THE FIRST OF EXCHANGE (SECOND UNPAID)</p> <p>PAY TO THE ORDER OF <i>Brown Brothers & Co.</i></p> <p><i>Eight thousand pounds</i> STERLING</p> <p>VALUE RECEIVED WHICH CHARGE TO THE ACCOUNT OF</p> <p style="text-align: right;">Guaranty Trust Company of New York</p> <p>to Guaranty Trust Company of New York</p> <p>33 LOMBARD ST. N.Y.</p> <p>LONDON</p> <p>Nº A12815</p> <p style="text-align: right;">Paid 1000 \$ Paid 1000 \$</p>	<p style="text-align: center;">Guaranty Trust Company of New York</p> <p><i>L. 1000 \$</i> NEW YORK <i>February 24th</i> 1909</p> <p><i>Sixty</i> DAYS AFTER SIGHT OF THE FIRST OF EXCHANGE (FIRST UNPAID)</p> <p>PAY TO THE ORDER OF <i>Brown Brothers & Co.</i></p> <p><i>Eight thousand pounds</i> STERLING</p> <p>VALUE RECEIVED WHICH CHARGE TO THE ACCOUNT OF</p> <p style="text-align: right;">Guaranty Trust Company of New York</p> <p>to Guaranty Trust Company of New York</p> <p>33 LOMBARD STREET,</p> <p>LONDON</p> <p>Nº A12815</p> <p style="text-align: right;">Paid 1000 \$ Paid 1000 \$</p>
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transfer as cover, thus gaining an extra six days in which to use the funds obtained from the sale of his sixty-day draft.

If the credit is to be renewed, the New York banker will draw a second long bill and use the proceeds of its sale to buy cover for the first. By doing this, he will avoid paying out of his own funds the purchase price of the cover; and the obligation of his London correspondent will not be terminated, but extended through the life of the second bill. But the second bill must be drawn for a larger amount than the first.

The original draft, now mature, was drawn for eight thousand pounds and this amount must be placed in the hands of the acceptor for its redemption; the second draft, therefore, must be drawn for a large enough amount to be equivalent to eight thousand pounds in demand drafts at the New York sight rate on London. Now, the long rate is always lower than the sight rate, as we know; hence, the second long bill will not be worth its face value in sight drafts.

To illustrate this point, let us assume that the spread between the sight rate and the rate of a sixty-day banker's bill is .0275 at the time when the New York banker undertakes to cover the original long bill. To give precision to our illustration, we will suppose that the two rates are 4.85 and 4.8225 at the time in question.¹ The banker's problem is to draw a long bill whose sale price will suffice to buy eight thousand pounds in sight draft at the sight rate of 4.85. The long bill must, therefore, sell for \$38,800 (8000×4.85). Given the rate of 4.8225 for the long bill, its face must be 8045.4 ($38,800 \div 4.8225$). The second long bill sold at this rate will buy cover for the first, but, obviously, the indebtedness of the drawing banker will be increased in the process of extending the loan.

It is sometimes the practice for the drawing banker, who is obliged to cover a maturing long bill, to "swap" the second bill for the amount of cover required. This exchange is made with another banker in his market who can use the long bill to make delivery on a futures contract, or in some other manner, and is willing to exchange demand drafts for it. The practice, in this case, is to swap equal amounts — in our illustration, a long bill of eight thousand pounds for demand drafts of the same amount — and, to square accounts, the holder of the long bill pays the holder of the demand drafts the difference between the long and sight rates of exchange multiplied by the face of the bills. Given the rates of exchange used in the preceding illustration, the swap would be effected by the exchange of a sixty-day sterling sight bill of eight thousand pounds for a sterling demand draft of the

¹ See calculation on p. 89.

same amount, the drawer of the long bill paying the drawer of the demand draft a premium of \$220 ($8000 \times .0275$). This constitutes an exchange of equal values in New York and results in giving each of the bankers the type of sterling bill which he needs. Swaps of this kind are very frequent occurrences in the New York market.

To sum up the relationships created by the drawing of a long bill by one banker of another: The drawing banker obtains an advance of funds on the strength of his correspondent's credit. The advance is not made by the correspondent, for he pays out no money of his own at any stage in the operation. The buyer of the banker's long bill in New York *may* bear the burden of this advance, though he does not bear it of necessity; for in buying the bill he will pay its present (discounted) value, and this sum he is at liberty to recover by selling it in the open money market of London at the time of acceptance. Only if the buyer chooses to retain the acceptance until maturity will he make an advance of funds; otherwise — and this is the almost universal practice — the burden will be passed on to that investor in the foreign money market who buys the acceptance.

37. Finance bills. The term *finance bill* is applied to those drafts whose object is solely to effect a loan of funds between the money centers involved. A little reflection will disclose the fact that the banker's long bill results in an advance of funds to the drawing banker only when the purchase of cover is postponed, for if the cover has been bought previously to the sale of the bill, or is bought at the same time, the transaction will not increase the funds in the hands of the drawer. A great proportion — perhaps the majority — of bankers' long bills do not represent lending operations. There are many transactions in which they can be used to recover money already expended in foreign exchange. A common transaction of this nature is the sale of a banker's long bill to offset previous purchases of commercial bills, usually documentary payment bills, whose redemption at maturity, or by prepayment on the part of the drawee, will increase the banker's foreign balance at some future date. The purchase

of payment bills always leaves the banker in doubt as to when, and by what amount, they will add to his foreign credit, and, consequently, in doubt as to the rate of exchange at which he can sell his demand drafts against their proceeds. To wait until the completion of each deal in such bills will expose the banker to the risk of adverse changes in the rates; to avoid this risk he may attempt to classify his holdings of documentary payment bills upon the basis of past experience, determining within limits how much they will increase his foreign credits upon certain definite future dates. He will then be prepared to sell his own long bills, so arranged in usance and amount as to exhaust these expected balances as rapidly as they accrue, taking his chance of overdrawing on certain days and failing to exhaust his credit upon others. Obviously, no borrowing is involved in such use of long bills, since cover is provided at least as soon as the bill is sold. It is when funds are raised by the sale of the long bill in advance of the expenditure necessary to provide cover that the bill serves the purpose of international lending, and is called a finance bill.

Finance bills are drawn when there is sufficient difference in the rates of interest obtaining in two markets to make it profitable to borrow in one and lend in the other. In explanation of this statement, we must repeat that the sale price in New York of a long bill drawn on London will be determined by the discount rate in the London money market, for it is in that market that the accepted bill will be offered for sale. The funds raised by the sale of this bill will lie in the hands of the New York banker to be loaned in his own market. Assuming, now, that the discount rate in the London market is 4 per cent, while the interest rate in New York is 6 per cent, it follows that the drawing banker can discount his bill at the lower rate and lend the proceeds at the higher during the time which elapses before he is compelled to buy cover. It is this divergence of the rates of interest which encourages the two correspondent bankers to put through a transaction in finance bills. The profit from the transaction may be divided in various ways. The drawing banker may take the initiative throughout, carrying through the operation at his own

risk and profit, and paying a commission to the accepting banker for the use of his name. Or, the accepting banker may take the initiative, instructing his correspondent to draw against him, specifying the use which may be made of the funds and paying him a commission for attending to the details of the transaction. Or, again, the operation may be carried through on joint account, with a division of profit or loss between the two correspondents. But these differences of detail do not change the nature of the finance bill, or the method of handling it, in any essential respect.

The exact nature of this process of borrowing in one market and lending in another requires some explanation. It does not involve the transfer of funds between the two markets, but only a redirection of the credit resources of each. Suppose, for example, that because there is a relatively large supply of loan funds in London and a relative scarcity in New York, the discount rate in London is 4 per cent at a time when money can be loaned on good security at 6 per cent in New York. If a finance bill for ten thousand pounds is drawn at ninety days' sight by a New York banker, the proceeds may be loaned on the day of drawing, while about six days must pass before the bill arrives in London and is presented for acceptance; hence the loan, made by the drawing banker in New York, will mature six days earlier than the acceptance, and the New York banker will have time to supply his London correspondent with cover.

Now, care must be taken to untangle the credit relationships created by this transaction. The New York banker has obtained funds by selling at its present value a ten-thousand-pound ninety-day draft on London, and he has the use of these funds for ninety days; this money he received, in the first instance, from that individual in New York who bought the finance bill. But this buyer will not have made an advance of funds; he has been under the necessity for making a remittance to England, and has bought the finance bill because it would serve as an instrument for making this remittance. If the finance bill had not been drawn, he would have been compelled to employ some other method for making his

remittance — demand drafts, or bankers' long bills covered in advance of drawing — a method which would have left no loanable funds in the hands of the drawing banker. He buys the finance bill and sends it to his English creditor who obtains the money due him from that investor in the money market of London who buys the bill after acceptance. Hence, the credit resources of London are absorbed in cancelling payments due from American debtors; while the money of these debtors remains in New York available for loans to the business men of that city. This is virtually equivalent to the transfer of loan funds from London to New York, since the effect of the operation is the enlisting of a part of London's credit in doing the business of New York; the effect is produced, however, not by an actual transfer of funds, but by a redirection of those funds within each market.

38. **The dollar loan.** Wherein lies the profit to the bankers who engage in operations in finance bills? To answer this question we must first distinguish between two varieties of finance bills: the *dollar* loan and the *sterling* loan. In the case considered above, the loan was made by the drawing banker in dollars and was repaid by the borrower in dollars, with interest. If any profit is to be left in the hands of the bankers when the transaction is completed, it will be due to the fact that the number of dollars repaid by the borrower will be more than sufficient to buy the demand drafts which cover the finance bill at maturity. Now the bankers cannot foretell what the sight rate for sterling in New York will be at the time the demand drafts are bought; they, therefore, do not know by what amount, if any, the money returned by the borrower will exceed the value of the ten thousand pounds in demand drafts which must be bought to close out the transaction. In other words, their profit is bound up with the future course of the exchange rates, and in making a dollar loan, through the agency of a finance bill, they are choosing to speculate in the exchange market of New York. To make this point clear, let us compute the effect upon the profit of the bankers which will follow certain changes in the sterling rates.

The conditions of the problem are these:

- (1) Sale of ninety-day sterling bill for ten thousand pounds at the existing rate of exchange; London discount rate, 4 per cent.
- (2) Loan of the proceeds in dollars at 6 per cent for ninety days in New York.
- (3) Purchase of demand sterling with the returns from the loan.

Let the sight rate on the day of sale be 4.85; the rate for a ninety-day bankers' bill derived from this quotation when the London discount rate is 4 per cent will be 4.809.

£10,000 @ 4.809	\$48,090.00
Interest ($\$48,090 \times .06 \times 90/365$)	725.10
Amount repaid, loan plus interest	<u>\$48,815.10</u>

The New York banker will have \$48,815.10 with which to buy sterling demand drafts to cover the finance bill. Assuming that the sight rate has not changed, this amount will buy:

\$48,815.10 ÷ 4.85	£10,064.97
Face of finance bill	<u>10,000.00</u>
Profit	£64.97

Assume, again, that the sight rate has risen to 4.88, the effect on the bankers' profit will be as follows:

\$48,815.10 ÷ 4.88	£10,003.09
Face of finance bill	<u>10,000.00</u>
Profit	£3.09

Again, let the sight rate fall to 4.83, and the profit will be affected as follows:

\$48,815.10 ÷ 4.83	£10,104.57
Face of finance bill	<u>10,000.00</u>
Profit	£104.57

These calculations show that, when the proceeds of a finance bill are used to make a loan in dollars, the profit from the transaction will vary inversely with variations in the rate for sterling sight drafts between the time of lending and the purchase of cover.

The risk run by the bankers when they draw finance bills for the purpose of making dollar loans is not unavoidable; it is possible for them to hedge the transaction at the time the bill is sold by buying a contract which calls for the delivery of the required amount of sight drafts on the day when cover is needed. The hedge will make it possible for the bankers to foretell what the cover for the finance bill will cost, and so to determine whether it is profitable for them to make the loan at all. If, rather than secure themselves against the risk of changes in the rates, they choose to take the chance of loss, it must be because they expect the rates to take a downward course; that is to say, they become speculators selling short of exchange in the hope of a break in the market. The appearance of dollar loans in large amounts, when these loans are financed by the drawing of bankers' long bills in sterling, mark, franc, or other exchange, is therefore an indication that the operators in the exchange market are predicting a decline in the quotations on the demand bills drawn in these moneys.

39. The sterling loan. In the preceding illustration, the finance bill was first sold, then the proceeds were loaned in the New York market. If, instead of proceeding in this manner, the drawing banker had loaned the original sterling long bill, the borrower agreeing to return an equal amount of sterling sight drafts at the term of the loan, the parties to the finance bill would have been relieved of all concern as to the future changes in the sterling rates. For, obviously, no possible fluctuation of the rates can alter the fact that the borrower must return exactly the amount of sight drafts required to cover the maturing finance bill. On the other hand, and for the same reason, neither of the bankers whose names appear upon the finance bill can make a profit from the transaction; unless the borrower fails to repay the loan, the receipts of the bankers on the day their finance bill becomes payable will just suffice to meet their obligation. When the sterling loan is made, therefore, the banks act as agents, receiving a commission for the use of their names, while the risk and the profit are taken by the borrower of the bill. We may

illustrate this distinction between the dollar and the sterling loan by means of the same data used in the preceding section.

Assume, then, that the interest rates of London and New York are 4 per cent and 6 per cent, respectively, and that the amount of the finance bill is ten thousand pounds. Some individual in New York, having arranged with the drawing banker to borrow the bill, will deposit collateral and contract to return ten thousand pounds in demand drafts ninety days later. No interest will be charged the borrower for this loan; why this is so, we shall see in a moment. The borrower will sell the finance bill in the open market; it will be forwarded to London for acceptance, discounted in the London market, and presented for payment ninety days later. But before it matures, the borrower in New York will have repaid the loan by giving the drawer ten thousand pounds in demand drafts, and these drafts will be placed in the hands of the London acceptor in time to redeem the finance bill. As their profit from this transaction, the two bankers will receive from the borrower of the finance bill a commission of something like $\frac{3}{8}$ per cent per annum on the ten thousand pounds.

The reason why the borrower of the finance bill was charged no specific rate of interest upon his indebtedness is this: an interest rate is concealed in the difference between the rate of exchange for the banker's long bill which he borrows and the higher rate of exchange for the sight drafts which he obligates himself to return. To make the loan effective for the purposes of his business, he must sell the long bill for dollars, and the rate at which he can sell it will involve a discount from its face at the rate of interest obtaining in the money market of London. When buying sight drafts with which to redeem his loan, the borrower will have to pay a price undiminished by discount; and unless a very marked change has taken place in the rates since the time the finance bill was borrowed, he will be required to expend more dollars than he received from the sale of the finance bill. Looking at the matter from the point of view of the drawing banker, this concealed interest charge can be clearly seen. When the ten thousand pounds in sight drafts are returned, the value of

these drafts in dollars will be greater than the value of a banker's long bill drawn for the same amount — as much greater, in fact, as the amount of the discount which the long bill will suffer when sold in the London market. The original finance bill has been growing in value as it lay in the hands of the investor in the market of London; this investor has been gaining interest as the bill which he bought at its reduced value has been approaching maturity. This interest gained by the investor in London is borne by the borrower in New York, who sold the finance bill at its discounted value and bought cover for it when it had matured. In addition to this loss of interest, the borrower must bear the commission charge of the bankers.

Usually the borrowers of finance bills are themselves bankers who intend to loan out the money raised from the sale of the bill at the higher rate of interest which obtains in the New York market. When their transaction is wound up and they buy the demand drafts with which to repay their loan, if any profit is to remain in their hands the interest earned by the money which they have been lending must exceed in amount the excess cost of the demand drafts plus the commission which they must pay. This may be illustrated by a simple calculation. Taking the same figures as in the preceding illustration, let us assume that a ten-thousand-pound ninety-day, sterling bill is borrowed when the discount rate in London is 4 per cent; that this bill is sold in the New York market and the proceeds loaned at 6 per cent for ninety days; the borrower of the sterling bill to return ten thousand pounds in sterling sight drafts and to pay $\frac{3}{8}$ per cent commission charge. Under the conditions assumed, if the sterling sight rate in New York on the day the finance bill is drawn is 4.85, the finance bill will sell at 4.809.

£10,000 @ 4.809	\$48,090.00
Interest ($\$48,090 \times .06 \times 90/365$)	725.10
	<hr/>
	\$48,815.10

When the loan has reached maturity, the borrower of the finance bill will have \$48,815.10 with which to buy the ten

thousand pounds in sight drafts which he must return to the drawer of the finance bill. If the sight rate has remained unchanged, the cost of this cover will be:

£10,000 × 4.85.....	\$48,500.00
Commission (3/8 per cent × 48,500 × 90/365) .	<u>44.85</u>
Cost of cover.....	\$48,544.85

Hence, his profit will be $\$48,815.10 - \$48,544.85 = \$270.25$. Clearly, the amount of this profit depends upon the behavior of the sterling sight rate between the time the finance bill is borrowed and the time cover is bought; any increase in the sight rate will cut down the profit, and any decline will augment it. Consequently, the borrower of a sterling loan (like the accepting banker in case of the dollar loan), unless he hedges his transaction by buying a contract for the future delivery of the required amount of sight drafts, is speculating — selling short of exchange in the hope of a break in the market. Consequently, the appearance in the market of finance bills in large quantity, whether they are of the dollar or the sterling loan varieties, may be taken as an indication that the exchange dealers are convinced that the sterling sight rate is about to fall. All that has been said above regarding the sterling finance bill applies without qualification to finance bills drawn in francs, marks, lire, and other foreign moneys.

In normal times, preceding the Great War, the currents of our foreign commerce were such as to cause seasonal swings downward and upward in the rates of exchange harmonizing with the rising and falling volume of commercial bills brought into the market. Finance bills have played their part in mitigating these fluctuations; for, whenever the relation of the discount rates in New York and foreign markets was favorable, certain banking houses made a practice of selling finance bills if a downward swing of the exchange rates was expected. This would be at a time when commercial bills were in light supply and bankers' demand drafts in large demand; for then the exchange rates would be high. But by selling finance bills at a time when bills were scarce, the bankers have added to the supply of available means whereby American business

men could make their remittances to foreign markets, and, consequently, their action has served to restrain the rates from rising to the extreme quotations to which the competition of the buyers might have pushed them. As has been said, the sellers of these finance bills have expected a decline in the rates; but they have been compelled to buy cover in the declining market and have, thus, restrained the rates from falling as low as they might otherwise have gone.

Until very recent years, similar selling in foreign markets of finance bills drawn on New York has been a rare occurrence. Many factors have coöperated to produce this result. Most American bankers have been prevented by the state of our law from accepting the drafts of foreign correspondents; moreover, there has not been in New York a smoothly functioning discount market in which acceptances could be sold; also, the rates of interest in New York have customarily been higher, not lower, than those of foreign centers. These handicaps have been removed to a large extent by changes which will be described in another place,¹ so that, to-day, finance bills on New York are drawn by foreign bankers in large amounts.

The speculative nature of the finance bill has caused it to be condemned by authorities on foreign exchange and by bankers in the world's money centers. The ready discount market of London, and the central position held by sterling exchange in all financial centers, has brought it about that by far the major proportion of finance bills were drawn in sterling. These bills periodically filled the portfolios of the money-lenders of London and absorbed the loanable funds of that city which might have been devoted to different purposes. The Governors of the Bank of England, and the more conservative private bankers of that market, have considered this recurring tendency to flood the discount market with bills drawn to finance foreign lending operations as one unworthy of encouragement. The practice of bankers who lend their names as acceptors of these bills has been viewed as a business enterprise of doubtful virtue, very similar to the practice of ac-

¹ See Chapter XIV.

commodation endorsement. This condemnation of the finance bill is to a large degree sound. The houses which accept these bills in great amounts do certainly run considerable risk that their correspondents, the drawers, may be unable to supply cover in time to take up the acceptances, in which contingency, the burden of redeeming them must fall upon the London bankers. It does not make for stability in the money market to have the assets of the banks committed to the support of speculative operations in foreign markets, for such a condition of affairs will make more direct and powerful the shock suffered by the credit structure of London from any business depression or panic in the money centers of other countries. Because of this attitude toward finance bills, they have frequently been discriminated against by the Bank of England when rediscounting the acceptances of brokers. To minimize the danger of loss, the accepting houses in London have made it their custom to demand the best collateral in the case of dollar or sterling loans in New York or elsewhere.

CHAPTER VII

COMMERCIAL BILLS

40. Definition and classification. At the basis of the foreign exchange business of the world lies the vast complex of international trade in commodities, services, and securities as a result of which the business men of different countries develop among themselves creditor-debtor relationships. Bills of exchange which arise from commercial transactions as an aid to the business man in his effort to collect payment from foreign debtors are, therefore, the primary material of the exchange market. Bankers' bills are of subordinate importance, being either the product of prior transactions involving the bills of merchants, or else of a temporary condition of the exchange market. Bills of exchange are called *commercial bills* when drawn by a business man, usually as a part of a commercial transaction which consisted of a sale made by him to a foreign customer.

It is inevitable that commercial bills vary greatly in form. So vast is international trade, so various the goods and the markets with which it is concerned, and so different the character and the credit standing of the business men who engage in it, that the bills of exchange which represent these countless transactions cannot be uniform. Bills of exchange which answer the purpose of an exporter of perishable fruits are usually of shorter term than those drawn against shipments of machinery; bills created by merchants of low credit rating are almost invariably supported by collateral security, while those of firms of the highest standing are sometimes negotiated by bankers on the strength of the drawer's signature alone; bills which pass through the banks of two nations of similar culture and business practice do not receive the same treatment as those which involve markets where mutual understanding is difficult. Consequently our description of

commercial bills cannot lay claim to completeness nor is it possible to treat of each method of handling the various kinds of bills in the exchange markets; we must limit our attention to those forms by means of which the preponderance of the world's trade is financed. The following classification embraces all the types of commercial bills whose appearance in the exchange market is a customary phase of international trade:

I. Commercial long bills.

A. Bills with documents attached, called *documentary bills*.

1. Acceptance bills: documents delivered against acceptance.
2. Payment bills: documents delivered against payment.

B. Bills free from documents: called *clean bills*.

II. Commercial bills at short sight or date.

III. Commercial letters of credit.

41. Commercial long bills. Payment for goods either in advance or cash on delivery is the exception in international trade; customarily the terms of sale are adjusted to allow the buyer a period of time in which to prepare for payment after the goods have been shipped. The length of this period is determined by bargain between buyer and seller just as are all other details of the commercial transaction, and in each case the bill of exchange must be drawn to mature at the end of the credit period. It is the custom of the exchange market to apply the term "long bill" to any draft whose term of life extends beyond thirty days. The draft running sixty or ninety days after acceptance is the typical credit instrument in the commercial relations of most of the world's chief markets.

However, the exporter who has sold his goods "on time" to a foreign customer is not usually content to wait until the end of the credit period before receiving payment for his goods. Ordinarily, he will attempt to realize upon the transaction by obtaining from a banker an advance of funds to the amount of his bill of exchange, bearing the cost of the

banker's services and the loss of interest ¹ which results from the discount of his bill, in order to escape the burden of waiting. Nor is the banker who acquires the exporter's bill usually content to wait until it matures before regaining possession of his funds. When the bill has received the acceptance of the drawer, it will have become an investment instrument of high standing, since it rests upon the credit of both drawer and acceptor. The banker may, accordingly, pass it on to some broker or money-lender in the discount market who is willing to invest in it for the gain of interest. For the sake of clarity, we shall for the present assume a uniformity which does not exist, and reduce the life-history of the typical commercial long bill to the following phases:

- (1) It is drawn by a merchant against a foreign customer or the customer's bank.
- (2) It is acquired by the drawer's banker by an advance of funds and forwarded to a foreign correspondent for presentment.
- (3) It is accepted by the drawee.
- (4) It is sold in the discount market by the correspondent bank and the buying banker's foreign balance is increased by the amount of the proceeds.
- (5) It is redeemed at maturity by the acceptor.

In the present chapter, we are concerned primarily with a description of the bills themselves, and not with the methods adopted by the exchange markets in handling them. It may be well, however, to pause long enough to remark that not all commercial bills pass through the stages outlined above; the chief differences appear with regard to the second and fourth stages. The exporter's bill may be of such a nature that the banker is unwilling to buy it outright, in which case the exporter must deposit it for collection and wait for the proceeds until the bill has been redeemed. Or, the banker, though unwilling to purchase the bill, may make use of it as collateral for a loan to the exporter of a part of its face. It is needless

¹ The exporter, normally, passes this interest loss on to the importer through higher prices. He could, however, retain the proceeds of the higher prices for himself if he cared to wait for his returns.

to say that when the second stage in the life-history of the bill is modified in this manner, the fourth stage is omitted entirely; that is to say, the banker cannot sell in the discount market an acceptance which is not his by right of purchase. Finally, if the bill is bought by the banker, he may choose to hold it as an investment; then his correspondent will be instructed to retain it until maturity instead of selling it in the discount market. These differences in procedure will receive attention at the proper place.

42. Documentary commercial bills. A commercial long bill is the financing instrument of a business transaction. If it is taken by the banker against an advance of cash to the exporter, the banker is extending credit to the end that the seller may receive his money immediately without depriving the buyer of the convenience of postponing payment. If taken by the banker for collection only, the burden of the advance falls upon the seller who has parted with his goods on credit of the buyer's promise to pay at a future date. In either case the seller bears a risk of loss, since the banker, even though he advances money to acquire the exporter's bill, will have recourse to him as drawer of the draft in case of default by the foreign customer. Both exporter and banker, therefore, have an interest in maintaining some control over the goods shipped until the buyer has made proper settlement according to the terms of sale — the banker, because the transaction of buying a commercial bill would otherwise rest merely upon the unsupported credit of the seller; the exporter, because, in the absence of such control over the goods he has sold, the transaction would be founded solely upon his trust in the foreign buyer. The security demanded by exporter and banker is usually provided by attaching to the bill of exchange documents of such a nature that the holder of the bill will retain ownership in the goods which it represents until he chooses to part with the documents. When this is done, the documents will form collateral security for the bill of exchange, and the resulting collection of instruments will comprise a *documentary commercial bill*. Nearly all commercial bills are of this kind.

To understand the nature of these documents, it is necessary to bear in mind that their purpose is to vest in the holder of the bill of exchange ownership in the goods, and that this ownership must be transferable from one holder to another as the bill proceeds on its way toward collection. These functions are discharged by the following instruments:

- (1) The bill of lading received by the seller when the goods are shipped.
- (2) The insurance certificate which will indemnify the owner in case of loss in transit.
- (3) The hypothecation slip which formally transfers ownership in the preceding documents to the holder of the draft.

In the practice of export trade, other documents are frequently attached to the bill of exchange in addition to the three mentioned above, such, for example, as the commercial and the consular invoices, but these are for the convenience of the importer and not for the security of the exporter or the banker and, accordingly, have no bearing upon the subject in hand. We shall now proceed to examine these documents in some detail.

1. *The bill of lading.* In foreign commerce as in domestic, the bill of lading given by the transportation company to the shipper is both a receipt for the goods shipped and a contract of affreightment. This document must be so drawn as to describe the shipment accurately, stating the number, weight, contents, and identification marks of the packages. This information suffices to enable the bill of lading to discharge its function as a receipt for the goods put aboard the steamer. To function as a contract of affreightment, the bill of lading must contain, in addition to the information given above, the name of the consignee, the port of destination, and the signature of the shipper. When thus drawn up and signed by the transportation company, the carrier is bound by the bill of lading to deliver the goods at destination to no other person than the one legally entitled to them.

Several copies of the bill of lading are prepared for every shipment, the exact number depending upon the needs of the

exporter, the steamship company, and the consular authorities. These duplicates are of two classes: *negotiable* and *non-negotiable*. The negotiable copies, only, can be used to secure possession of the goods on arrival; when properly endorsed, any one of them gives a legal holder title to the shipment. The non-negotiable copies are retained by the different parties as a matter of record.

The bill of lading may be drawn either to the order of the shipper, or in the name of the foreign buyer; the former is called an *order bill of lading*; the latter, a *straight bill of lading*. This difference has a significant effect upon the value of the bill of lading as collateral security for the exporter's drafts. When the order bill is drawn, the shipper (exporter) retains ownership in the goods during their transportation, and after their arrival, until he is induced to part with the bill of lading by endorsement. By endorsing this order bill in blank — that is, making it the legal property of the bearer and transferable without further endorsement — and attaching it to his draft, the exporter will place in the hands of the bankers the maximum of control over the shipment. The foreign buyer cannot, then, obtain his goods without inducing the bankers to release a negotiable copy of the endorsed bill of lading, and this, obviously, the bankers will not do until the buyer has performed his obligations as drawee of the exporter's draft. The straight bill of lading is not thus of service as collateral security for the bill of exchange. When drawn to the order of the buyer, the bill of lading gives him sole right to receive the shipment. In this case, he usually does not need the bill of lading to claim his goods; the steamship company will inform him upon arrival of their readiness to make delivery, and the goods will be turned over to him upon his surrender of a properly endorsed notice of arrival. The laws of some countries — for example, Columbia and Venezuela — prohibit the drawing of order bills of lading, prescribing that the goods be consigned directly to the importer. When, in conformity with these laws, a straight bill of lading is drawn, its possession by the bankers does not add to the security of the bill of exchange, and the bankers, accord-

ingly, are slow to negotiate drafts thus secured. It is the order bill of lading, however, which is typical of foreign commerce; in this instrument, the exporter and the banker find protection against loss from default on the part of the foreign buyer.

2. *The insurance certificate.* The ocean carrier, unlike the domestic carrier, is not legally bound to make good any damage suffered by the shipment while in transit, unless the damage results directly from negligence or fraud on the part of the company or its employees. For this reason, it is always essential that foreign shipments be insured against total or partial loss. For our purpose, it is unnecessary to inquire into the technicalities of marine insurance; like the bill of lading, the insurance certificate is usually made out to the order of the shipper, thus making possible a transfer of the claim to indemnification to each successive holder of the bill of exchange. This certificate in no wise improves the legal title in the goods which vests in the holder of the bill of lading, yet its addition to the documents attaching to a commercial long bill is necessary to perfect the banker's protection against loss from the transaction. The complement of order bill of lading and insurance certificate reduces to a minimum the risks involved in the buying of commercial bills of exchange, defending the buyer as it does, not only from bad faith on the part of the drawee of the bill of exchange, but also from the hazards of marine transportation.

3. *The hypothecation slip.* To "hypothecate" is to make a formal pledge of personal property as security to a creditor. With reference to the transaction we have been considering, the act of hypothecation is merely a formal declaration by the shipper that it is his intention to transfer legal title in the bill of lading and the insurance certificate to the holder of the draft which he draws against his foreign customer. This act of hypothecation may be performed separately each time the exporter sells a commercial bill to his banker; however, if the former has arranged for the financing of a series of foreign sales, he will probably be asked to sign a general letter of hypothecation. The letter of hypothecation is so drawn as

to secure for the bankers the utmost possible protection against loss, and the utmost freedom of action with respect to the shipment in the event that such action is necessary to protect their interests. A typical letter contains the following provisions:¹

- (a) The exporter declares his intention of delivering to the banker a series of bills of exchange with shipping documents attached, and agrees that the letter shall have the same force with respect to these documents as if a separate hypothecation were made to cover each transaction.
- (b) The conditions under which the shipping documents are to be delivered to the foreign buyer are carefully stated. It is customary for the banker to reserve the right to make partial deliveries of goods under terms satisfactory to himself when these conditions require payment by the buyer before the release of the shipping documents.
- (c) The exporter agrees to provide suitable insurance for each shipment; failing this, the banker is empowered to take out the insurance and charge its cost to the exporter. Insurance is to be in the name of the banker and for his benefit in case of loss. But any loss not covered by the insurance policy is to be paid by the exporter.
- (d) The procedure in case of default by the importer is carefully outlined. Ordinarily, the banker is instructed to protest the bill of exchange for non-acceptance and for non-payment, and the exporter agrees to pay to the banker the amount of the bill upon first notice of protest, together with all costs and charges.
- (e) Wide powers are given the banker and his agents to seize the goods. Seizure may occur because of non-acceptance or non-payment by the importer, or because of bankruptcy or failure by the importer, or for any other reason which, in the opinion of the banker, excuses the seizure as a protective measure. The goods

¹ See form 8, pages 168-69.

when seized are to be sold by the banker directly or through a broker, and the proceeds of the sale to be applied to the replacement of the funds advanced to the exporter through the purchase of the bill of exchange. All costs, fees, commissions, etc., in connection with the seizure and sale, are to be charged to the exporter. It is also specifically stated that this procedure in no way releases the exporter from his liability as drawer of the bill of exchange.

- (f) The banker reserves the right to call for additional collateral security, of any form satisfactory to him, in case there is danger of loss for any reason.
- (g) The banker is not to be held responsible for any default by broker or other agent employed by him in connection with the seizure and sale of the goods.
- (h) A general clause is inserted in the letter to the effect that no event, other than a satisfactory redemption of the bill of exchange, shall release the exporter from his liability to the banker, or other holder of the bill, arising from his position as drawer.
- (i) The letter is made terminable upon notice by the exporter.

43. Documentary instructions. The completed documentary bill is, therefore, a small bundle of instruments securely fastened together so that they cannot become separated in the mails, comprising (1) the exporter's draft for the value of the goods shipped; (2) the bill of lading, usually drawn to order and endorsed in blank, whose possession bestows legal right to claim the shipment at destination; (3) in the absence of a general letter of hypothecation, an hypothecation slip which formally pledges the shipping documents as collateral to the banker who handles the bill of exchange.

To govern the bankers in their handling of the transaction, the exporter usually adds a set of instructions at the time the bill is placed in the banker's hands. Because of the distance which separates the markets and the opportunities for misunderstandings to arise, it is exceedingly important to the drawer of the bill that these instructions be sufficiently

FORM 8. GENERAL LETTER OF HYPOTHECATION

To the Hongkong and Shanghai Banking Corporation.

As you may from time to time purchase from or negotiate for me/us Bill or Bills of Exchange drawn or endorsed by me/us with collateral securities, it has been agreed between us that the stipulations contained in this Memorandum shall be deemed to be continuing and ambulatory, and are to apply to all cases in which such Bills of Exchange may at any time either directly, or through other persons, be negotiated with or sold to you by me/us and this Memorandum shall have the same force until I/we shall give you notice of my/our intention to terminate it, as if a separate Memorandum were signed by me/us on each purchase or negotiation.

I/we authorize you, or any of your Managers, or Agents, or the Holders for the time being, of any such Bill or Bills as aforesaid (but not so as to make it imperative) to insure any goods forming the collateral security for any such Bill or Bills of Exchange from sea risk, including loss by capture, and also from loss by fire on shore, and to add the premiums and expenses of such insurances to the amount chargeable to me/us in respect of such Bill or Bills, and to take recourse against such goods in priority to any other claims thereon, or against me/us, without prejudice to any claim against any endorser or endorsers of the said Bills, for reimbursing yourselves, or other the person or persons paying the same, the amount of such premiums and expenses, and also to sell any portion of such goods which may be necessary for payment of freight, insurance, and expenses, and generally to take such measures and make such charges for commission, and to be accountable in such manner, but not further or otherwise than as in ordinary cases between a merchant and his correspondent. And I/we consent to the goods being warehoused at any public or private wharf or warehouse selected by the Drawees or Acceptors of the Bills, unless you offer an objection to such wharf or warehouse.

I/we hereby authorize you, or any of your Managers, or Agents, or the Holders for the time being of any Bill or Bills of Exchange as aforesaid, to take conditional acceptances to all or any of such Bills, to the effect that, on payment thereof at maturity, the Documents handed to you as collateral security for the due payment of any such Bill or Bills shall be delivered to the Drawees or Acceptors thereof, and such authorization shall be taken to extend to cases of acceptance for honour. Subject nevertheless to the power next hereinafter given, in case the Drawee shall suspend payment, become bankrupt, or go into liquidation during the currency of any such Bill or Bills.

I/we further authorize you at any time or times before the maturity of any Bill or Bills of Exchange, as aforesaid, to grant a partial delivery or partial deliveries from time to time of any part or parts of such goods, in such manner as you or the Acceptors of such Bill or Bills of Exchange, or their representatives may think desirable to any person or persons on payment of a proportionate amount of the invoice cost of such goods, or of the Bill or Bills of Exchange drawn against same.

I/we further authorize you, or any of your Managers, or Agents, or the Holders for the time being of any Bill or Bills of Exchange as aforesaid, on default being made in acceptance on presentation, or in payment at maturity, of any of such Bill or Bills, or in case of the Drawees or Acceptors suspending payment, becoming bankrupt, or entering into liquidation during the currency of any such Bill or Bills, and whether accepted conditionally or abso-

lutely, to sell all, or any part of the goods forming the collateral security for the payment thereof at such times and in such manner as you, or such Holders may deem fit, and, after deducting usual commission and charges, to apply the net proceeds in payment of such Bill or Bills with re-exchange and charges; the balance, if any, to be placed at your option against any other of my/our Bills, secured or otherwise, which may be in your hands, or any other debt or liability of mine/ours to you, and subject thereto, to be accounted for to the proper parties.

In case the net proceeds of such goods shall be insufficient to pay the amount of any such Bill or Bills, with re-exchange and charges, I/we authorize you, or any of your Managers, or Agents, or the Holders for the time being of such Bill or Bills as the case may be to draw on me/us for the deficiency, without prejudice nevertheless to any claim against any endorser or endorsers of the said Bills for recovery of the same or any deficiency on the same; and I/we engage to honour such Drafts on presentation, it being understood that the Account Current rendered by you or by such Holders, shall be sufficient proof of sale and loss.

I/we further authorize you, or any of your Managers, or Agents, or the Holders for the time being of any such Bill or Bills as aforesaid, whether the aforesaid Power of Sale shall or shall not have arisen at any time before the maturity of any such Bill or Bills, to accept payment from the Drawees or Acceptors thereof, if required so to do, and on payment to deliver the Bills of Lading and Shipping Documents to such Drawees or Acceptors; and, in that event, you or the Holders of any such Bill or Bills are to allow a discount thereon, not exceeding _____ per cent. per annum for the time they may have to run as follows:

At one half per cent. per annum above the advertised rate of interest for short deposits allowed by the leading London Joint Stock Banks, if payable in Great Britain.

At the current minimum rate of discount of the National Banks of France, Italy and Belgium, if payable in those countries.

At the current rate of rebate for Documentary Bills, if payable in Germany, Switzerland or the United States.

At the current rate of rebate allowed by the Exchange Banks, if payable at any place east of Suez.

The delivery of such collateral securities to you shall not prejudice your rights on any of such Bill or Bills in case of dishonour, nor shall any recourse taken thereon affect your title to such securities to the extent of my/our liability for the time being to you as above, and it is agreed that you are not to be responsible for the default of any Broker or Auctioneer employed by you for any purpose.

Dated.....this.....day of.....
One Thousand Nine Hundred and.....

Witness to the Signature of.....
.....
.....
.....
.....Witness.....
.....Occupation.....
.....Address.....

.....

definite and comprehensive to inform the bankers of the procedure to be followed in the event of certain contingencies which affect the drawer's interests. Such instructions are especially necessary when the bill is not sold to the banker, but placed in his hands for collection; for then the banker acts merely as an agent for the drawer and does not desire broad discretionary powers. In all cases, however, the drawer of the bill bears a credit risk which should impel him to provide with care against misunderstanding or bad faith on the part either of the foreign customer or of the bankers through whose hands the bill passes.

It is, of course, impracticable in a book of this nature to attempt a complete description of these instructions in all their possible varieties. The drawer must be governed in each instance by the nature of the transaction, the business practice of the foreign market concerned, and the character and responsibility of his foreign customer. The problem, however, is of sufficient practical importance to business men who have to do with foreign bills that its general characteristics should be considered. There are certain contingencies of major importance which should without fail be covered by the documentary instructions. These are:

- (a) A request from the drawee for an extension of time in which either to accept or to pay the bill of exchange.
- (b) A request from the drawee for a surrender of the bill of lading at an earlier date than that fixed by the terms of the bill of exchange.
- (c) An absolute refusal by the drawee to honor the bill at acceptance or at maturity.

The drawee's request for an extension of the date of acceptance is usually based upon the fact that the goods have not arrived and that, consequently, no examination is possible to assure the buyer of the seller's discharge of his duties in conformity with the terms of sale. Extension of payment is usually requested when the condition of the drawee's business is temporarily such as to make prompt payment burdensome, or when the state of the exchange market is seriously adverse to the drawee. In both cases, it might well be that the

drawer of the bill of exchange, if he were on the ground and could discuss the matter with the drawee, would concede the reasonableness of the request and be willing to grant it. But the *banker* has power to make these extensions only if authority has been given him by the drawer, explicitly or by implication, to exercise his judgment in the matter. In the absence of such instructions, the banker can act only at the risk of releasing the drawer from his liability by reason of the fact that he, the banker, exceeded his powers. Consequently, if the instructions touching this point are absent or vague, the result is apt to be a rigid enforcement by the banker of the terms of the bill of exchange which may injure the good-will of the foreign customer toward the exporter.

We are not at this point prepared to discuss the conditions which govern the surrender of the bill of lading to the drawee of the bill of exchange. This matter will be taken up at length in the sections which follow. It should be made clear, however, that the drawer must not rely upon the banker to disregard the terms of release of the bill of lading stated on the draft, no matter how reasonable the drawee's request and how willing the drawer to accede to it, unless appropriate instructions have been given the banker. For in this case, also, the banker can act on his own initiative only by running the risk of the drawer's demanding release from his liability on the plea of improper behavior by the banker.

The question which arises in the event of the drawee's refusal to accept or to pay is usually whether to protest the draft. The value of the protest to the *drawer* of the bill varies with the laws of different countries. Under the Spanish law, which includes the law of Spanish-American republics, the protest makes possible speedy executive action and the recovery of damages by attachment of the drawee's assets, whereas, otherwise, a long and expensive civil suit would be necessary. In Anglo-Saxon law, its chief value is in the proof which it gives that dishonor has actually occurred. From the point of view of the *banker*, the act of protest has a different significance; for, unless the documentary instructions specifically waive protest, failure to protest a dis-

honored draft within the time limit set by the law releases all parties secondarily liable — including the endorsers and the drawer. The banker, therefore, will never fail to protest unless authorized to refrain from doing so. Nevertheless, occasions arise when it would be to the drawer's interest as an exporter of goods to forego the right of protest, and when he would be willing so to instruct the banker if the facts were known to him. Hence, to avoid misunderstanding, the documentary instructions should give the banker a qualified power to waive protest or else should make a specific demand for protest under all conditions.

One of the largest banks in New York states its request for instructions from its clients in the following form:

Advise us whether the draft is to be protested in case of non-acceptance or non-payment. Also state whether you wish cable advice of non-acceptance or non-payment.

Be specific as to instructions regarding the surrender to the drawee of the shipping documents covering the goods for which the drafts are drawn; that is, whether, in the event of the draft being a time draft, such bills of lading and other documents are to be surrendered upon acceptance or upon payment. The absence of definite instructions in this respect renders necessary cabling to New York for instructions with the consequent expense.

Firms having agents or representatives in the foreign field should, likewise, inform the bank of the precise powers delegated to such representatives, in order that the bank may know just how far it is to accept instructions regarding any question which may arise on collection items. If it is intended to confer power on the agent or representative to demand documents of the correspondent bank, to dispose of or reship the goods in event of non-payment, etc., or to extend time on disputed drafts, such authority should be incorporated in a regular power of attorney. A copy of such power should be deposited with this bank to be forwarded to our foreign branches and correspondents.

In the absence of a duly appointed agent at destination, it is advisable to leave to the discretion of our branch manager the steps to be taken on uncollected items. Where definite instructions to protest are received, the instructions will, of course, be followed, although in many cases the protest of an uncollected item is unjust to

the foreign drawee, particularly where the merchandise has not yet arrived, or has arrived in bad condition, or is not what was ordered. If this matter of protest, however, be left to the discretion of the branch manager or correspondent, the transaction may be adjusted amicably without recourse to this procedure. The instruction, "no protest," should never be given, as the branch manager or correspondent is thus estopped from using this leverage to compel payment should circumstances render such action advisable.

When required, the bank will endeavor to dispose of merchandise on uncollected items, employing the services of a local broker for this purpose.

An examination of these instructions will show that they are intended to apply chiefly to "collection items," with regard to which the banker acts as agent of the drawer and can act only to the extent of the authority bestowed upon him, and in the manner required by the drawer. The events concerning which the banker chiefly expresses desire to receive explicit instruction are those of dishonor by the drawee of the bill of exchange — either non-acceptance or non-payment. He must know whether or not to protest the bill, and if so, whether or not to postpone protest in case the drawee has a reasonable excuse for non-performance of his duty. The expenses of protest, sometimes rather heavy, must be borne by the drawer, who, also, must bear the risk of losing the patronage of his customer in case the latter is offended by the action. How to dispose of the goods in case of an uncollected item is also a matter requiring definite understanding between banker and exporter. These goods belong to the exporter; they may be sold at public or private sale, or turned over to a local agent for distribution among other customers in the same market, or reshipped to another port. The banker cannot proceed in any of these matters further than his instructions warrant; if he does so, he becomes responsible to the exporter and can be made to bear any loss arising from his conduct. In view of this risk, the banker may, in the absence of instructions, cable for advice at the exporter's expense, which will increase the costs of the transaction. Banks frequently supply their clients with printed blanks to be filled

out and attached to the other documents which accompany a collection bill of exchange. The following is an example of one of these blanks:

THE FIRST COMMERCIAL BANK OF NEW YORK

DEAR SIRs:

We enclose for collection the undermentioned draft with documents as enumerated. The surrender of documents to drawee is conditional upon the fulfilment of instructions as indicated by cross (x) in margin.

<i>Draft</i>	<i>Number</i>	<i>Documents</i>
Number.....		Commercial Invoice
Drawer.....		Consular Invoice
Drawee.....		Bills of Lading
Where payable.....		Insurance Certificate
Date payable.....		Certificate of Origin
Amount.....		Weight Certificate
Drawn at.....		Declaration of Shipper

Instruction

Documents against Payment
Acceptance

Protest for Non-Payment
Non-Acceptance

Permit the drawee privilege of inspecting the goods before accepting.

Hold for arrival of goods.

Payable at collecting bank's selling check rate on New York.

Payable at check rate on New York, remitting proceeds by cable, charges for our account.

Interest to be collected at from date of issue until approximate arrival of funds in New York.

Allow drawee interest at per annum for anticipated payment./

All charges for account of Drawer
 Drawee

Waive charges if refused by drawee.

In case of need refer to and advise immediately by cable.

Kindly collect this draft through.....
 (Signed).....

The bundle of instruments which comprises a documentary bill of exchange is usually made out in duplicate or triplicate, the whole collection being known as a *complete set of bills*. This practice, very probably, arose when the uncertainties of ocean mail made it advisable to send the drafts forward by different steamers, thus reducing the risk of non-arrival. It is continued largely because it gives the banks useful documents of record as a check upon the transaction. Also the duplicate bills are put to technical uses when the banker buys the exporter's draft for investment.¹ In ordinary practice one of the duplicate bills of exchange is attached to each set of shipping documents and is stamped, in order of drawing, *first of exchange*, *second of exchange*, *third of exchange*. The wording of each of the bills shows that it is a conditional order, payable only in event that none of the others has been paid. Thus the first of exchange will read:

Pay to the order of, second and third unpaid.

And the second will read:

Pay to the order of, first and third unpaid.

Payment of one of these drafts is sufficient to render all the others void and to relieve the drawee of further obligation; however, the one upon which payment is effected may legally be any one of the duplicates, and not necessarily the first of exchange.

¹ See Section 67.

44. **Documentary acceptance bills.** When the documentary bill is the financing instrument of a commercial transaction, the importer cannot obtain his goods until he has so far discharged his obligations under the terms of sale as to induce the holder of the bill of exchange to release the bill of lading and other shipping documents.¹ Whether these documents will be released upon acceptance, or be held until payment, is one of the details of the transaction covered by the agreement between the two merchants. However, the merchants do not have unqualified freedom of choice in this matter. Obviously, the exporter will be concerned, if he plans to sell his bill of exchange, not to accept such terms as will limit the market for his bill, for a ready negotiation of the bill will be as essential to his profit as is the sale of his goods. When the terms call for delivery of the shipping documents against acceptance, all collateral disappears before the draft is collected, and the acceptance which remains in the hands of the banker will rest merely upon the credit of the two parties — drawee and drawer. The exporter will find it more difficult to obtain an advance of funds upon such a bill because of the temporary nature of the collateral; indeed, if the bill is a *trade bill*,² his banker will very probably either refuse to negotiate it or will demand the deposit of some other form of collateral security. When the banker does agree to purchase such a bill, it is because of his confidence in the good faith of the acceptor, or of the very high credit rating of the drawer, or for both of these reasons. So it happens that when the importing merchant has engaged the services of a banker as the acceptor of the bill, documents will always be delivered against acceptance, the credit standing of a bank being sufficiently high to make good the lack of collateral. Also a small number of mercantile houses of high reputation are able to instruct their foreign creditors to draw bills of this kind upon them directly with the assurance that the bankers of the exchange market will not refrain from financing the trans-

¹ Recall, in this connection, the difference between the *order* and the *straight* bill of lading. See page 164.

² See definition, page 91.

action. When the act of acceptance is sufficient to give the importer possession of the goods, the bill of exchange is given the name, *documentary acceptance bill* (abbreviated *D.A.*).

The superiority of the documentary acceptance bill from the point of view of the importer should be apparent. It enables him to gain possession of his goods thirty, sixty, or ninety days before he is required to pay for them. In many cases, these intervals of time are sufficient to permit the conclusion of the transaction for which the goods were bought; that is, if the importer is a commission merchant, the goods may be resold before the draft falls due; if a manufacturer, the finished product may be turned out and passed on to the wholesaler or jobber. When the goods pass in this manner through the hands of the importer during the interval which elapses between acceptance and payment, the transaction is practically self-financing, since the proceeds of the sale will be in hand to meet the cost of buying before the draft matures. This is one reason why the bankers' acceptance has attained such widespread use in international trade. The best established importers frequently make arrangements with a bank or finance house to accept the drafts drawn by the foreign sellers, finding the greater convenience of the documentary acceptance bill sufficient to warrant the payment of a commission to the banker for this service. Until recently, this practice was unknown in the American market, partly because of a lack of knowledge of its merits and partly because of a weakness of the banking laws; but in late years, and especially since the beginning of the Great War, the acceptance of bills by American bankers for the account of importers has been growing rapidly and along with its growth has come an increase in the number of documentary acceptance bills drawn against our imports.

It should be noted further that the choice of the documentary acceptance bill is determined to some extent by the nature of the merchandise of which the shipment is composed. When the bill of lading is to be surrendered only against the *payment* of the bill of exchange, some arrangement must be made to care for the goods between the time of their arrival

and the date of payment, an interval which may extend sixty days or longer. In the next section we shall discuss the methods adopted for the storage of goods in such cases, but it may be remarked at this point that not all wares are of such nature as to permit of extended storage without deterioration. Grain may be held for a long time without loss of quality, and so we find that the larger share of our wheat bills are drawn documents against payment. But fruits, drugs, chemicals, foodstuffs, and many other wares cannot be held for extended periods without deterioration. The importer of such goods attempts to provide an acceptance of such quality that his foreign creditor may arrange terms of sale calling for the drawing of acceptance drafts. Sterling cotton bills in America are almost universally acceptance bills, though this is true, probably, not so much because of the nature of the commodity as because of the high standing of the Lancashire importers and their custom of providing bankers' acceptances.

45. Documentary payment bills. The term *documentary payment bill* (abbreviated *D.P.*) is applied to the commercial long bill whose documents will be released only upon payment by the drawee. What has been said above concerning the factors which determine the choice of an acceptance bill will apply, also, to the choice of a payment bill. The nature of the bill will result, in the first instance, from the terms of sale concluded between the two merchants, but these terms will be dictated, in part, by the banker upon whom the exporter depends for aid in financing the transaction. It is the practice of banks to require payment bills in the case of most drafts drawn by merchants upon other merchants in order to reënforce the acceptance with collateral security in the form of a lien upon the goods which figure in the transaction. Hence, it may be said that the standard form of trade acceptance is drawn to prevent the importer from gaining possession of the merchandise until he has paid the bill, or, at least, has made some arrangement for payment more satisfactory than mere acceptance.

Now, some markets are so distant from the export point

that the difference in time required by mail and freight steamers is sufficient to allow the acceptance to run to maturity before the arrival of the goods, though both are dispatched at the same time. For example, the American importer of raw silk from the Orient may find that a draft drawn against the shipment will arrive so far in advance of the freight steamer that the time between acceptance and maturity will elapse before the silk reaches New York. When such is the case, the disadvantage of the payment as compared with the acceptance draft is negligible, since the latter could not in any case hasten the delivery of the goods to the importer. This, however, is the exception to the rule in international trade. It much more frequently happens that the goods arrive many days before the payment date of the draft, and the importer is prevented from gaining possession of them because of the retention of the bill of lading by the banker. In this event, the importer, provided he does not wish to wait until the maturity of his draft before obtaining the goods, may have recourse to one or the other of two expedients: (1) an arrangement with the banker which will relax the terms of the bill of exchange and allow delivery of the goods before payment; (2) prepayment of his acceptance before maturity.

In explanation of the first of these alternatives, it should be recalled that when a banker *buys* the exporter's bill of exchange, he is the party primarily interested in retaining collateral security until the acceptance is paid; any arrangement which this banker chooses to make regarding the surrender of the bill of lading will, probably, not meet with opposition from the exporter. In fact, the letter of hypothecation which transfers to the banker the exporter's lien upon the shipment frequently provides in express terms that the banker shall be free to surrender the bill of lading at his discretion. The importer, however, does not deal directly with this banker, but with his foreign representative and the degree of difficulty with which he meets in an attempt to gain possession of the bill of lading will depend upon his standing as a client of this foreign representative and also to some extent upon the cus-

tom of his market. The foreign representative, it must be remembered, is not the owner of the acceptance, but the agent of the owner, and is presumably bound by the instructions of his principal. Because of a settled business custom governing the type of merchandise which has been shipped, or because of the high standing of the importer, the banker who has bought the bill may have done so with the understanding that an arrangement would be made to surrender the shipping documents before payment and may have instructed his foreign representative to that effect. Furthermore, even in the absence of express permission, the correspondent, because of his faith in the importer, may undertake on his own initiative to depart from the documentary instructions and release the bill of lading, though in so doing he will be taking upon his own shoulders the obligation to indemnify the owner of the draft for loss through default of payment. If we assume for the sake of simplicity that the correspondent is instructed to release the bill of lading before payment, the arrangement made with the importer may take one of the following forms:

- (a) The bills of lading may be surrendered against no greater security than the importer's written receipt. It is apparent that such liberal treatment will be accorded only those firms of the highest credit standing whose patronage is valued by the banker. The receipt adds nothing to the security of the acceptance which the banker already holds, being nothing more than an expression of intended good faith on the part of the importer. This simple arrangement, though not unknown, is relatively rare in international trade; it is not considered good banking practice, since it multiplies the banker's risk and subjects him to the hazards of the client's business. To give strength to the receipt, endorsement by other reputable parties is sometimes required.
- (b) A second plan, adaptable to certain kinds of goods, provides that they be stored by the banker until the importer has had time to make his sales, when they will be released either in installments or in a single lot for

delivery to the importer's customers. The proceeds of the sale are paid over directly to the banker and applied by him to the redemption of the importer's acceptance; the latter, however, is not released from his obligation as drawee and must make good any discrepancy between the receipts from the sale and the face of the acceptance. By this arrangement, the importer never really acquires legal ownership of the goods at all, with the exception of that portion, if any, which remains after the funds accumulating in the banker's hands have equaled the face of the draft. The method is sometimes employed by houses importing general merchandise for distribution to the wholesale trade. It is not adaptable to the needs of the manufacturer who imports machinery or raw materials for his own use, since it prevents the importer from becoming legal owner of the goods, as explained.

Moreover, from the banker's viewpoint there are certain decided objections to the practice of making partial deliveries of goods before the drawee has performed his obligations. The practical difficulties are great. It is almost impossible for the banker to be sure that the importer is withdrawing no more than the permitted fraction of the goods for which he makes payment; this fraction is one of values and not of quantities, and the banker or his agent may be deceived as to the relative values of the different packages of which the shipment consists. It is not difficult, also, for the importer to create fictitious sales for the purpose of deceiving the banker. When the same importer has several payment drafts and several consignments of goods held by the same banker at the same time, it is possible for him, by these devices, to withdraw those goods for which a good market exists, leaving the others as a form of security whose value dwindles in spite of the banker's caution. English bankers, for these reasons, rarely adopt the practice; it is, however, widespread in certain countries, and especially in the Far East.

(c) A third method, and one more frequently employed in the United States is the delivery of the shipping documents in exchange for a *trust receipt*. This document is carefully drawn to define the rights and duties of the banker and importer with respect to the goods. Its essential characteristic consists in the agreement that the goods are the property of the bank delivered to the importer in trust for a certain specified purpose, the latter being bound to maintain their identity distinct from the rest of his assets and to hold them subject to seizure by the banker. The delivery of raw materials under control of the trust receipt is very common in the United States where it probably originated. The English bankers condemn the practice; often, as buyers of payment bills, they refuse to sanction the delivery of the goods against a trust receipt, in which case the local banker handling the collection in a market where the device has a recognized standing, frequently exceeds his authority, avails himself of this method of making deliveries, and thus makes himself liable to his correspondent for the drawee's obligation. Though the trust receipt is devised to control the conduct of the importer after he has received the goods, opportunities for fraud are always present; hence, it is the banker's faith in the character of his client which leads him to make delivery of the shipping documents. The efficacy of the trust receipt also varies in different countries because of the varying degrees to which the laws recognize the bank's property in goods after they have been delivered to the acceptor of a bill; this recognition, in the United States, is more nearly unqualified than in other countries, and this fact, in part, accounts for the popularity of this device with our bankers.

The form of the trust receipt is adapted to the character of the goods and the purpose of the importer with regard to them. One type is employed in cases, similar to that discussed in the preceding section, where the goods are to be delivered only after their sale by the importer has been con-

FORM 9. TRUST RECEIPT

Received from THE FIRST COMMERCIAL BANK OF NEW YORK the following goods, their property, specified in the Bills of Lading per S.S.....dated..... marked and numbered as follows:

(Description of goods)

In trust to deliver the same to..... who have purchased the same for..... payable in..... and to obtain from the purchaser the proceeds of the sale of the same.

In consideration of the delivery of said goods to me/us in trust as above I/we agree to deliver them immediately to the said purchasers and to collect the proceeds of sale, and immediately deliver such proceeds to THE FIRST COMMERCIAL BANK OF NEW YORK in whatever form collected, to be applied by them against the acceptances of THE FIRST COMMERCIAL BANK OF NEW YORK on my/our account, under the terms of Letter of Credit No.....issued for my/our account, and to the payment of any other indebtedness of mine/ours to THE FIRST COMMERCIAL BANK OF NEW YORK. It is understood, however, that if such proceeds be in notes or bills payable, they shall not be so applied until paid, but with liberty to THE FIRST COMMERCIAL BANK OF NEW YORK to sell or discount, and so apply net proceeds.

THE FIRST COMMERCIAL BANK OF NEW YORK may at any time cancel this trust, and they may take possession of said goods until the same have been delivered to said purchasers and the proceeds of sale received from them, and thereafter of such proceeds, wherever the said goods and proceeds may then be found, and in the event of any suspension or failure or assignment for the benefit of creditors on my/our part or of non-fulfillment of any obligation or of non-payment at maturity of any acceptance made by me/us under said credit, or any other credit issued by THE FIRST COMMERCIAL BANK OF NEW YORK on my/our account, or of any indebtedness on my/our part to them, all obligations, acceptances, indebtedness, and liabilities whatsoever shall thereupon (with or without notice) mature and become due and payable.

Dated, New York City.....

(Signed).....

FORM 10. TRUST RECEIPT

Received from THE FIRST COMMERCIAL BANK OF NEW YORK the following goods, their property, specified in the Bill of Lading per S.S.....dated..... marked and numbered as follows:

(Description of goods)

and, in consideration thereof I/we *hereby agree to hold said goods in trust* for them, as their property, with liberty to sell the same for their account, and further agree, in case of sale, to hand the proceeds to them to apply against the acceptances of THE FIRST COMMERCIAL BANK OF NEW YORK on my/our account, under the terms of the Letter of Credit No.....issued for my/our account and for the payment of any other indebtedness of mine/ours to THE FIRST COMMERCIAL BANK OF NEW YORK.

THE FIRST COMMERCIAL BANK OF NEW YORK may at any time cancel this trust and take possession of said goods, or of the proceeds of such of the same as may then have been sold, wherever the said goods or proceeds may then be found and in the event of any suspension, or failure, or assignment for the benefit of creditors, on my/our part, or the non-fulfillment of any obligations, or of the non-payment at maturity of any acceptances made by me/us under said credit, or under any other credit issued by THE FIRST COMMERCIAL BANK OF NEW YORK on my/our account or of any indebtedness on my/our part to them, all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon (with or without notice) mature and become due and payable. The said goods while in my/our hands shall be fully insured against loss by fire.

Dated, New York City

(Signed)

FORM 11. TRUST RECEIPT

(DOCUMENTS FOR WAREHOUSING)

Received from THE FIRST COMMERCIAL BANK OF NEW YORK Bill
of Lading per S.S.....dated.....
for the following goods, their property, marked and numbered as
follows:

(Description of goods)

imported under the terms of Letter of Credit No.....
issued by them for my/our account the said Bill of Lading to be used
by me/us for the sole purpose of entering the above described prop-
erty and the United States Custom House at the Port of
and of storing the same in the name, and as the property, of THE
FIRST COMMERCIAL BANK OF NEW YORK, and subject only to their
order, I/we hereby agreeing to so store said property and to hand the
storage receipt to the said THE FIRST COMMERCIAL BANK OF NEW
YORK, when obtained.

I/we also agree to fully insure said property against fire, the loss,
if any, payable to said THE FIRST COMMERCIAL BANK OF NEW YORK,
and to hand to them the policies of insurance thereon.

Dated, New York City.....

(Signed).....

summated.¹ All payments in connection with the sale are to be handed to the banker, regardless of the fact that the importer's draft may not be payable. In other cases, deliveries are made to the importer before he has made his sale, under agreement that the proceeds will be handed immediately to the bank. This type of receipt is especially adaptable to the uses of the importers of raw materials, who are thereby enabled to withdraw these materials from storage as they are needed for manufacture, and to fill orders on specification.² Still another form of receipt is used in cases where it is necessary for the importer to obtain the shipping documents for the single purpose of clearing the goods through the Custom House. The importer is then bound to store the goods to the bank's order and to place the warehouse receipt in the banker's hands. This last method, of course, does not grant the importer any real control over the shipment.³

By one of these methods, importations may be financed by documentary payment bills without actually exacting payment from the importer in advance of delivery, thus materially reducing the inconveniences of the payment bill as an instrument of international commerce. Failing these devices for releasing the shipping documents, the acceptor may have recourse to *prepayment* of his acceptance. The prepayment of a debt always lies in the power of the debtor, but the remission of interest on the unexpired portion of the debt cannot be claimed as a legal right in case of prepayment. An acceptance, though it bears no explicit rate of interest, is bought by the bankers at a discount, interest being involved in the difference between the purchase price and the face value. This interest the banker can gain by holding the acceptance through its term of life; and if he cares to insist upon this right, the acceptor has no power to compel him to forego any part of this gain by virtue of an offer to redeem the bill in advance. But, as we have seen, it is ordinarily not the intention of the banker to hold a bill of exchange as an investment. In the case of most acceptance drafts, he will instruct his correspondent to sell the instrument in the open

¹ See Form 9, page 183. ² See Form 10, page 184. ³ See Form 11, page 185.

market as soon as acceptance is obtained upon it. In the case of payment drafts, these not being discountable in the money market, an offer from the acceptor to prepay his debt at the time of acceptance or afterwards will usually find the banker willing to agree to a remission of interest, since the funds returned by the prepayment may be used with profit in other ways. Many importers have for years prepaid all their acceptances as soon as the goods have arrived, assuming their right to receive a rebate of interest as if this right had the sanction of law; and the bankers who buy long bills drawn upon these importers do so in full knowledge of the fact that prepayment will take place before the maturity of the acceptance.

The amount of rebate allowed an acceptor who prepays is governed by the practice of the market in which he lives. In England alone is the practice of prepayment so widespread and of such long standing that special machinery has developed in the money market to deal with it. There a special rate, called *the retirement rate of interest*, by means of which the amount of rebate to be allowed upon prepayment is determined, is published periodically. In the London money market, this retirement rate is established at a point from $1/4$ to $3/4$ per cent *lower* than the rate of discount for prime commercial long bills; it is the latter, and higher, rate which determines the banker's buying price for a bill, hence prepayment leaves him a margin of profit. The student can easily verify this statement by a little exercise with pencil and paper; let him discount a given sum at 4 per cent and again at $3\frac{1}{2}$ per cent: the former result will represent a banker's buying price and the latter his selling price in case of prepayment. The holder of an acceptance need not, therefore, object to prepayment on the ground that it will rob him of the profit which induced him to buy the draft. In markets other than London, the retirement rate is not fixed with precision, being determined in some cases by the parties to the bill of exchange and written into the documentary instructions; in others, governed by a somewhat variable practice among the bankers of the country. With few exceptions, however, pre-

payment with rebate of interest takes place in all the exchange markets of the world.

When it is the importer's intention to prepay the acceptance, either at the time of acceptance or a few days later, the documentary payment bill becomes from his point of view much like a demand draft or commercial bill at short sight. Yet there are reasons why the payment bill serves his purpose better than either of the other two. To understand these reasons, we must first recall that the dominant motive impelling an importer to prefer a long bill to a sight draft is his desire to postpone payment until after he has opportunity to dispose of the goods. A sight draft will usually arrive in advance of the shipment, if both are sent by the foreign seller at the same time, and so is likely to result in payment in advance of delivery. A bill at short sight — that is, drawn for less than thirty days — may have a similar result. Bills of exchange cannot legally bear an indeterminate date of maturity, whereas the delays of ocean traffic make the arrival of the goods at the port of destination indeterminate. Hence, a bill drawn at short sight against a freight shipment will mature on the day the goods arrive only by a stroke of luck.

However, even if sight drafts could be handled in such a way as to guard against payment in advance of delivery, there remain sufficient reasons why the importer may prefer the payment draft with the option of prepayment. This choice between prepaying his acceptance or allowing it to run to maturity is a valuable consideration to a merchant whose transactions are subject to the fluctuations of the market. If he should have difficulty in disposing of his goods, he will be protected against a hurried liquidation due to pressure to meet the purchase price. On the other hand, if he turns over the merchandise quickly, a way is open to reduce the cost of the transaction by prepaying his acceptance at a discount. In brief, he is free to prepay his draft and obtain his goods, or to let the draft mature and goods lie in storage according to the dictates of self-interest.

A variation of the practice of prepayment has added to the value of this option to the import merchant. This is the per-

mission given him of paying in advance any portion of his acceptance that he wishes to pay, allowing the balance to run to a later date or to maturity. When a portion of the acceptance is prepaid, the goods are released from the storehouse in amount proportionate to the payment, and are, therefore, available in allotments large or small as need arises for them. To illustrate, let us assume that a miller in England has imported six thousand bushels of wheat from America and has accepted a ninety-day payment draft for their value, the wheat to be warehoused by the banker pending payment of the acceptance. Assume, further, that the miller can use his wheat profitably in three equal amounts every thirty days. The first installment can be withdrawn the day the wheat arrives, say ten days after the acceptance of the draft, by prepayment of one third of the amount of the bill at eighty-three days' discount (in England three days' grace are added to the term of the bill); the second installment will be released thirty days later upon payment of another third of the bill at fifty-three days' discount; and the final installment after another thirty days upon payment of the balance of the bill at twenty-three days' discount. Under this arrangement, the miller is neither compelled to pay for his goods before he can make use of them, as would have happened if the transaction had been financed by a sight draft, nor to wait longer than he wishes in order to get them, as he would have been compelled to do in the absence of the option of prepayment.

46. **Clean bills.** A small number of commercial long bills are *clean*; that is, free from attached documents. Business houses of high standing which have had dealings for many years sometimes develop a degree of confidence in each other so high that the seller requires no collateral security in support of the buyer's promise. In such cases, one of the motives — namely, the desire of the exporter for control over the goods until payment is made — which cause the drawing of documentary bills is absent. It is then the practice of the exporter to mail the bill of lading and other documents directly to the importer some days before drawing against the ship-

ment. After sufficient time has elapsed to allow the goods to arrive, a bill of exchange is drawn and offered for sale (or collection) to the exporter's banker. Now, just as the exporter will waive collateral security only in favor of his best customers, so the banker will buy the resulting bill of exchange only from exporters of the highest standing; for it will be recalled that the banker relies upon the drawer's contingent liability for security against dishonor by the drawee. This process of selection exercised by exporter and banker has as a necessary consequence the fact that no commercial long bills, free from documents, are to be found in the exchange market which do not bear names of the highest credit rating both as drawer and as drawee. Students of foreign exchange have sometimes been puzzled by the information that clean bills often command better rates of discount from the bankers than do documentary bills, but this discrimination in their favor results, not from the fact that they are clean, but from the fact that the parties to them are of the highest standing. To state it otherwise, the premier standing of some business men enables them at the same time to draw clean bills and to sell these bills at unusually favorable rates; but documentary bills bearing the same names would command equally favorable rates.

Clean bills are preferred by business men to other forms of drafts, not because they command better rates (for, as has just been said, merchants who are able to sell clean bills could command the lowest rates for any of their drafts), but because of the superior convenience of the clean bill. By receiving his bill of lading directly from the exporter, the importing merchant is freed from whatever inconvenience is involved in negotiating for its release from the bankers who are financing the transaction. Moreover, his receipt of the bill of lading in advance of the arrival of the goods provides security against delay and a possible break in the continuity of his business operations which might result if the goods were to be held up on the docks.

47. **Commercial bills at sight and short sight.** It is estimated that ninety per cent of the international trade of the

world is financed by commercial long bills, the majority of which are drawn at sixty or ninety days' sight; however, the commercial bill payable at sight or a small number of days after sight is not unknown. We repeat that the bill of exchange arising from a particular transaction is but one of a number of details covered by the terms of sale, and, like the details of price, quality, and quantity of the goods, is open to many possible adjustments at the time the bargain is struck. Thus both parties sometimes agree that the buyer shall pay for the goods cash on delivery, and that, to give effect to this agreement, the seller shall draw a sight or short sight draft against the buyer or his banker. Or, the goods may be sold on open book account with the agreement that, when payment is due, the seller collect by drawing a sight draft against the buyer or his banker to arrive approximately on the day of payment.

Strictly interpreted, the sight draft imposes on the banker the duty of making presentment immediately upon its arrival, which, because of the discrepancy between mail and freight time, may lead to payment in advance of the delivery of the goods. To avoid this result, customs have arisen in some markets which modify the strict meaning of the sight draft, causing the bankers to postpone presentment for some days, or until the arrival and inspection of the goods. When so treated, the sight draft becomes virtually a bill drawn for a short period after date and will be so considered when bought by bankers familiar with the customs of the importing market. The draft drawn for three, five, or seven days after sight is likewise, in most cases, the result of cash on delivery sales, the date of payment being calculated to compensate the difference between mail and freight time. These are usually documentary payment bills drawn against perishable goods. They are, however, adaptable to any transaction in which the buyer intends cash payment; hence, with the development of faster freight steamers they are coming into vogue as a substitute for long payment bills in the case of many buyers who have customarily prepaid their acceptances. This is said to be true of our sales of cotton to the largest English importers.

Short commercial bills, however, remain the exception to the rule in foreign trade.

48. Modification of the commercial bill. We may now take account of variations in the form and treatment of commercial bills which appear in our relations with certain markets of the world. Thus far it has been assumed that the exporter will draw the bill in the money of the importer and that the latter will discharge his obligation by making payment to a local banker of the face of the bill in this local money. The result, when the bill of exchange is drawn in this form, is that both exporter and importer deal in the money of their respective countries, and, also, that the importer is called upon to pay only the fixed amount stated on the face of the bill. This is the usual, though not the universal, practice. The principal exceptions which we shall consider either require payment by the importer in some form of foreign exchange, or else leave the amount to be paid open to the influence of fluctuations in the rates of exchange. These exceptions are especially important with regard to two groups of markets: (a) South Africa and Australia; (b) South America.

The Australasian colonies of the British Empire have the same monetary system as England and are closely related to London through their banking structure. Importers in these markets, dealing through local branches of London banks, frequently establish credits in London against which they instruct the exporters to draw for the value of the goods shipped. The credit in London may be created by paying into the local colonial bank in local money the equivalent of this credit at the bank's current rate of exchange, a process tantamount to buying a bill of exchange payable in London, the proceeds to be held in that city subject to the draft of the foreign exporter. Various differences in practice arise with regard to this payment by the importer. It may not be made until the draft drawn by the exporter and accepted in London is approaching maturity, though to postpone payment in this manner, the importer must come to some agreement with the London bank through its local branch, whereby acceptance of the exporter's draft can be secured in consideration of the im-

porter's promise to remit the funds required to redeem the draft before maturity. This process is very similar to that which is followed when a commercial letter of credit is employed; it will be discussed at length in the following chapter and we shall, therefore, pass it over in this place without further explanation. In any case, the amount paid by the Australasian importer will be governed by the bank's rate of exchange for London bills, on the assumption that the payment will be converted into a sterling bill which will be sent to London as an offset for the exporter's draft. But in practice, especially if the importer deals with a local branch of a London bank, the payment may be carried upon the accounts of the two banks for an extended period without remittance by the colonial branch to the London office. Regardless of these details, however, this method of paying through London for imports from other markets is equivalent to covering the exporter's bills with exchange drawn on a third country. From the point of view of the exporters, the practice has the merit of making it possible to draw London bills against goods sold in Australasia, and, thus, to take advantage of the relatively stable rate on sterling exchange.

When this process of collecting through London is not adopted, the commercial bill of exchange arising from sales of our goods in Australasian markets will be drawn directly upon the importer. Then it will usually bear what is known as the *Colonial Clause*. The amount due is stated in the importer's money (which is the same as English money) and the bill of exchange bears the following additional words: "Payable with exchange (British and Colonial Stamps added) at the current rate in London for negotiating bills on the Colonies." The inclusion of this clause has two important effects; in the first place, it makes the amount payable by the importer a variable amount, governed by the rate quoted in London on bills of like tenor drawn on Australasian markets; in the second place, because of the variable nature of the importer's payment, the bill is worth its face value in London at the time of drawing, regardless of its length of life. The second effect of the Colonial Clause is important from the

standpoint of the drawer, since it gives him a London credit of a fixed amount which he can sell at the sterling *sight* rate of exchange. To make clear these two features of the bill bearing the Colonial Clause, some explanation is necessary.

To repeat, the Colonial Clause requires the importer to pay the face amount of the bill "*with exchange* at the current rate in London" for bills of this character, and, in addition, to pay all stamp charges. The phrase "*with exchange*" is not used in its ordinary sense — denoting bills of exchange — but should be expanded to read, "*with exchange charges.*" A bill drawn on Melbourne which calls for the payment of one thousand pounds "*with exchange*" exacts from the drawee at maturity the payment of the face of the bill (£1000) *plus* whatever premium is necessary to make the bill worth this face amount at the time of drawing — that is, to free the bill from the necessity of discount in order to find its face value. The amount of this premium, it is obvious, will be determined by the London quotation on similar bills drawn on Melbourne, for the quotation is calculated in such a way as to express the difference between the face value of a time draft on Melbourne and the present value of such a draft.

To illustrate, assume that the bill in question is drawn at thirty days' sight and that the London quotation on such bills is 98. This quotation means that ninety-eight pounds will be given in London for each one hundred pounds payable in Melbourne thirty days later — a discount of two per cent. The Colonial Clause compels the drawee to pay this two per cent in addition to the face of the bill, and also any stamp charges which may be applied to the bill in London and Melbourne. If this bill, bearing the Colonial Clause, is offered for sale in London, the bankers need not discount it to find its present value, because the drawee when he redeems it will pay enough in addition to the face to make it worth one thousand pounds when drawn. In strict theory, the rate which determines this premium payment of the drawee should be the rate current at the time the bill is drawn, and not the rate current when the bill is paid; for the purpose of the premium payment is to make the bill worth its face *when drawn*. In actual

practice, however, it is the rate current when the bill is paid which determines how much "exchange" the drawee must bear; but in the long run any differences between these two rates are equalized, and the London bankers negotiate these bills on the assumption that they are worth their face when drawn.

Consider, now, the effect of the Colonial Clause upon the receipts of the American exporter who offers it for sale to his banker. We have just seen that a bill bearing this clause will be accepted in London at its face value; to the New York banker, therefore, it is equivalent to a sterling sight draft. It will increase the banker's London credit by its full face amount upon arrival; if it is bought by the New York banker, he can sell at once his own sterling sight draft for the same amount, knowing that the exporter's bill will arrive in London with the same mail as his own sterling demand draft, and that the two will offset each other. Hence, the exporter will expect to sell his commercial long bill bearing the Colonial Clause at the sterling *sight* rate of exchange; this is higher than the sterling long rate by the amount of the discount which the long bill usually suffers when sold after acceptance.¹ It comes, then, to this: the exporter is enabled by the Colonial Clause to sell his goods on time without suffering loss of interest; the importer bears this loss by agreeing to pay "exchange" at the time his draft matures. Another effect of the Colonial Clause, important from the standpoint of the exporter, is the fact that it enables him to sell bills payable in Australasia at the relatively stable sterling sight rate of exchange. This reduces his risk of loss through exchange fluctuations.

Desire to avoid risk of exchange accounts, also, for the customary practice of making bills drawn on South American markets payable by the importer with foreign bills of exchange. The monetary systems of these countries have never been very stable; few of them have to-day an unqualified gold standard; irredeemable and depreciated paper money has

¹ See pages 93 f., where the relation of the long rate to the sight rate is explained.

been the medium of exchange over most of the continent throughout its history as a group of independent republics. Rates of exchange for bills drawn in these money units have, in the past, been subject to wide and sudden fluctuations, so violent as to preclude the use of such bills by exporters who wish to avoid speculative risks in their foreign business. In their efforts to utilize the bill of exchange (chiefly as a collection instrument) in their trade with South America without at the same time running serious risk of loss, American exporters have adopted either of two expedients: (a) drawing their bills to require payment at maturity in a specified amount of dollar exchange; (b) drawing to require payment in sterling exchange. This is known as *payment by return draft*; payment is not consummated until the arrival of the funds in the exporter's market.

The commercial bill so drawn as to require payment by return dollar draft bears on its face an amount stated in dollars and cents and includes these words: "Payable in legal currency at the bank's drawing rate on the day of payment for sight drafts on New York." To redeem such a draft, the importer must either deposit the designated amount in the form of dollar sight drafts, or pay to the banker who holds his acceptance enough local currency to purchase these sight drafts at the current rate on New York. The sight drafts with which payment is made in South America will be the property of the exporter who drew the bill of exchange, or of his banker, if the latter has bought the exporter's bill. They must be forwarded to New York and there presented for encashment before the transaction is finally cleared up. Since most of these bills are taken for collection, the exporter must wait during the entire period required to mail the bill to South America for acceptance plus the term of life of the bill, plus the mail time of the return draft. But he is freed from all risk of loss by reason of any fluctuation in the rates of exchange, since his bill, payable in dollars, is not converted at any stage of its history into a foreign currency. If he succeeds in selling his bill to a banker, the buying price will be its face value minus interest during the period which must

elapse before the arrival of the return draft, minus bankers' commissions. Hence, the use of this type of commercial bill, whether sold to the banker or left for collection, involves for the exporter a relatively heavy interest charge, but no risk of exchange. Being forewarned of this loss of interest at the time of stating his terms of sale, the exporter can include it, together with bankers' commissions, in the sale price of his goods and thus pass it on to the importer. From the latter's point of view, the bill requiring a return draft in dollars is obviously less desirable than one drawn in his own money, since it throws his business transaction open to risks of exchange whose magnitude he cannot foresee. This makes it impossible for him to foretell with precision what his importation is to cost, and acts as a handicap to the conduct of his business.¹

Somewhat more complex is the second type of bill employed in our South American trade — that is, the bill payable in a designated amount of sterling exchange. The exporter employing this type of bill must price his goods in sterling, draw upon the importer for the proper amount in that money, and write on the face of his bill, "Payable in legal currency at the bank's drawing rate for ninety days' sight drafts on London." In some cases, though rarely, this clause will designate sterling sight drafts instead of sterling bills at ninety days' sight; this matter of the usance of the return draft is of some importance to the importer as we shall see in a moment. In either case, upon maturity of the exporter's bill, the importer must make payment by depositing with the banker who holds his acceptance sufficient local currency to purchase the return draft at the current sterling rate of exchange, or else deposit the designated sterling bill itself. As in the case of a return draft in dollars, payment is not effected until the funds arrive in New York where they are the property of the exporter or his banker, if the latter bought the bill on the South American importer.

Merchants in South America have preferred that the return draft be a long bill rather than a sight bill because the former

¹ He can, of course, guard against this risk by "hedging."

opened up to them the possibility, with the aid of their bankers, of postponing actual payment for their goods and thus resolving the importation into a long term credit transaction. In explanation of this matter, let us assume a typical case. An American exporter has shipped goods to Rio and drawn a bill requiring a return draft of one thousand pounds sterling thirty days after acceptance. If this return draft is to be a *sight* bill, the Brazilian importer must make actual payment for his goods at the maturity of his acceptance; his banker can supply him with a sterling sight bill only by drawing upon his London balance, and this he will not do unless he can cover his draft at once. This cover he will buy with the money received from the importer for whose benefit the return draft is drawn; thus the importer will be called upon to make payment at the maturity of his acceptance. If, now, allowing for difference in mail and freight time from New York, we suppose that the importer's goods arrived fifteen days later than the bill of exchange which the exporter drew upon him, we find that he has gained possession of his goods only fifteen days before his acceptance matures. (The bill of exchange, it must be recalled, was drawn for thirty days' sight.) These fifteen days, accordingly, represent the maximum period allowed the importer to turn over the goods before paying for them, under the assumption that he redeems his acceptance with a return sight draft. But suppose that the return draft is a ninety days' sterling bill. It is possible for the importer to obtain such a bill from his banker without making immediate payment for it, though to do so he must have sufficient credit with his banker, and must pay commissions. The banker can draw a bill at ninety days' sight upon his London correspondent who will accept it upon presentation and undertake to pay it out of funds received from the drawer ninety days later. Since immediate cover is not needed for the return draft, the importer's banker may give him the benefit of this extra period by requiring payment, not when the return draft is drawn, but ninety days later when it is time to remit cover to London. This makes possible a lengthening of the time allowed the importer to dispose of his goods before he need make actual payment for them.

This extra credit period is not without cost to the importer in South America, but we can best explain this question of cost by examining the method employed by the American exporter to govern his drawing when a sterling return draft is specified. Returning for a moment to the procedure in the case of a dollar return draft, we recall that the exporter computed the amount for which he drew upon the South American buyer by adding to the sale price of his goods interest for the time which must elapse between the mailing of his bill from New York and the arrival of the return draft, plus bankers' commissions. The same procedure will form the base of his calculations when the return draft is to be sterling. But, in this case, the return draft must be turned into dollars at the appropriate sterling rate of exchange before the exporter has received payment for his goods. As we know, the rate of exchange for a sterling sight draft is higher than the rate for a sterling long bill; hence, the amount for which the exporter draws upon his South American customer will be *smaller*, if the return draft is drawn at sight. Perhaps a simple example will help to make this clear. Let us assume the following data: (1) the exporter's goods are valued at \$1000 in New York; (2) the time which elapses between the shipment of the goods and the arrival of the return draft is ninety days (mail time both ways plus the life of the exporter's thirty-day sight draft on the importer); (3) bankers' commissions are \$10. This gives us the following computation:

Value of goods in New York	\$1000
Interest ($1000 \times .06 \times 90/360$).....	15
Commissions.....	10
	<hr/>
	\$1025

If the return draft is to be drawn in *dollars*, the exporter will draw upon his foreign customer for \$1025 and include in his bill the words, "Payable in legal currency at the bank's drawing rate for sight drafts on New York." He can discount his bill for \$1000 with a New York banker and thus receive the correct price for his goods; or he can leave the bill for

collection and receive a payment ninety days later of \$1025, thus gaining interest for himself.

If the return draft is to be in *sterling*, the exporter must draw his bill in sterling, and this will necessitate his turning the \$1025 which he requires for his goods into pounds. Inquiry at his bank will inform him that a return sight draft will command a rate, let us say, of 4.85; while a return draft of ninety days' sight will command a rate of 4.80. The difference between these two rates is determined chiefly by the discount which the sterling long bill suffers when sold in the London market.¹ Turning \$1025 into pounds sterling at the rate of 4.85 gives the result, £211 6s. 7 1/2d. ($1025 \div 4.85$). The same sum turned into pounds sterling at the rate of 4.80 gives the result, £213 10s. 7 1/2d. ($1025 \div 4.80$). Thus, if the terms of sale specify that the exporter shall draw requiring a return draft in sterling sight, he will draw for £211 6s. 7 1/2d. and the importer must redeem the bill by remitting a sterling sight draft of this amount; if, however, the terms specify a return sterling draft of ninety days' sight, the exporter will draw for £213 10s. 7 1/2d., and the importer must remit a sterling long bill of this amount. It will be seen at once that the exporter is not concerned about the usance of the return draft, since he is at liberty to adjust the face of his bill so as to obtain a predetermined number of dollars. In either case, if he sells the bill to his banker, he will receive \$1000 for it; and, if he deposits it for collection, he will receive ninety days later a sterling bill which will sell for \$1025.

Consider, now, the effect of the usance of the sterling return draft upon the South American importer. If the return draft is at sight, he must buy £211 6s. 7 1/2d. at the maturity of his acceptance at the rate of exchange then current in his market; if the return draft is a ninety-day bill, he may obtain one drawn for £213 10s. 7 1/2d. at the maturity of his acceptance by binding himself to supply this amount of cover in sterling sight drafts ninety days later, at the rate then current. This ninety days of credit, therefore, will have cost him what-

¹ See pages 88 f., where the relation of the sterling sight rate to sterling long rate is explained.

ever he is required to pay for the extra two pounds and four shillings, plus the commission demanded by his banker for the service of supplying the sterling long bill in advance of cover. Will it be worth his while to obtain at this cost an extension of the time within which he is required to pay for his goods? The answer depends upon whether the interest rates in Rio are higher than in London, or *vice versa*. It must be repeated that the amount by which the sterling long bill exceeds the sterling sight bill is determined by the interest rate in the London market where the long bill is discounted after acceptance; it is, therefore, at this rate that the importer obtains his ninety days' credit when he employs a long return draft for this purpose. His other alternative is to borrow for ninety days in his own market, redeem his acceptance in sterling sight exchange, and repay his loan ninety days later; in this way he can postpone actual payment for his goods for the same length of time. In the past, however, the interest rates in all South American markets have been very much higher than in London. It has been cheaper for South American importers to obtain credit by employing long sterling return drafts, even at the added cost of bankers' commissions, than to borrow from their own bankers. Accordingly, they have employed sterling sight return drafts only to a limited extent.

From the point of view of American exporters, the use of commercial bills bearing the return draft requirement renders a double service; in the first place, it throws the interest cost and the cost of banking service upon the buyer in the foreign market; secondly, it frees the exporter from risk of loss due to adverse fluctuations in the rates of exchange. When the return draft is not in dollars, but in some foreign money, the exporter, to be sure, must resolve the return draft into dollars at a rate of exchange, and, thus, apparently runs some risk of loss. But he discovers what this rate will be before drawing upon the importer and adjusts the face of his bill so as to avoid the risk. The importer, on the other hand, cannot escape risk of loss from exchange fluctuations, since he obligates himself to buy exchange at a future date and at a rate

which cannot be foreknown; hence, he does not know with certainty what his goods have cost until after they have arrived and, perhaps, have been sold. Obviously, the more violent the customary fluctuation of the rates of exchange applying to the type of bill which is specified for the return draft, the larger the element of risk in the transaction from the standpoint of the importer. In this regard, sterling has been much preferred in times past; because of a broader demand and supply for sterling in the exchange markets of South America, fluctuations in the sterling rates have been confined within limits relatively narrow as compared with the dollar rates. The changes which have taken place since the outbreak of the Great War have, however, partially removed the impediment in the way of employing dollar return drafts in South America, and, as a consequence of the greater stabilization of the dollar rates, remittances of dollar exchange have become much more common in our trade with that continent.¹

Before dismissing this subject, one other modification of the commercial bill should be considered. In the transaction just discussed, the exporter passed the interest charges on to the importer by adding them to the sale price of his goods and drawing for the full amount. But the same object is obtained, in the case of some collection drafts, by adding an explicit rate of interest to the face of the draft itself and requiring the importer to pay the increased amount when the draft falls due. Thus the exporter's bill will read, "Payable in legal currency at the bank's drawing rate on the day of payment for sight drafts on New York, with interest at six per cent per annum from the date of drawing to the approximate date of arrival of return funds in New York." This interest clause appears almost solely in collection drafts, since the bankers insist on the inclusion of the interest in the face of the draft itself when they agree to buy the exporter's paper. Commercial bills bearing the interest clause are common in collections of payments due from most of our foreign markets outside of Europe, with the exception of certain

¹ See the discussion in Chapter XIV.

South American countries where they are prohibited by law. Foreign buyers obtain credit, by this method, at the rate current in the United States, in preference to borrowing from their own bankers and paying cash for their importations, because of the relatively low rates of interest in our country compared with those of most non-European markets.

NOTE TO CHAPTER VII

The abnormal credit conditions which have followed the war have led to a much more frequent use than normally of the commercial bill carrying modifying clauses. An officer in one of the largest New York banks states that the Foreign Discount Department of the bank at the present time (1921) uses the following modifying clauses when negotiating commercial bills.

Africa: "Payable with exchange as per endorsements plus English and Colonial stamps."

Australia, New Zealand, India: "Payable with exchange and English and Colonial stamps at the current rate for negotiating bills in London on the Colonies."

China, Japan, Java: "Payable at the current rate of exchange for check on New York with interest at seven per cent per annum from date hereof until approximate date of arrival of cover in New York, together with all collection charges and other expenses."

England, Argentina, France, Italy, Poland: "Payable at the current rate of exchange for approved bankers' check on New York together with interest at the rate of six per cent per annum from the date hereof until the approximate date of arrival of cover in New York."

These clauses will be placed upon the bill by the bank by means of a rubber stamp, after the bill has been taken from the client and before it is forwarded for presentment. Advice has been received, however, that in at least one South American country (Uruguay) the clause will be held invalid if stamped upon the bill, and that it must be incorporated in the body of the bill if it is to be binding upon the drawee. The practice of altering the terms of a bill by the banker's addition of "rubber stamp" clauses, even when done for the purpose of conforming to the varying conditions of the foreign markets, is of questionable merit. The drawer is released from liability,

if a dishonored draft has been changed by the addition of such clauses, unless the banker can show authorization. The safer practice would seem to be to draw the drafts in the first instance bearing the necessary clauses; or, else, for the drawer, after acquainting himself with the meaning of, and necessity for, these clauses, to give his banker authority in writing to make the required additions.

CHAPTER VIII

LETTERS OF CREDIT

49. **Purpose and nature of letters of credit.** The different types of commercial bills thus far discussed have had one feature in common: they have been drawn by one merchant upon another on the security of the goods which were changing hands. Reference has been made in the course of this discussion to a somewhat different kind of commercial bill — one drawn by the seller of the goods upon a designated banker whose services have been engaged by the buyer as an aid in financing the transaction. A *credit* may be defined as a contract of a banker to place a specified sum at the disposal of a client, subject to certain requirements stated in the contract; the authorization, upon the strength of which the accredited party draws against the banker, is called a *letter of credit*.

For the purpose of an exporter, a draft drawn against a banker is superior to one drawn upon a merchant, because of the greater ease with which the former can be sold and the higher and more stable rate which it commands. In buying commercial long bills, bankers express their faith in the credit of the drawer, relying upon him to make good any default of the drawee; only to a secondary degree do they place reliance in the security of the goods which serve as collateral. The risk of default on the part of a banker is ordinarily much smaller than the risk of default by a merchant; for this reason, bills of exchange drawn on bankers will always be bought outright from the drawer, whereas those drawn on merchants may be taken for collection only. Moreover, the banker's purchase price for a commercial long bill is governed by the rate of discount which will apply to it when sold in the foreign market after acceptance, and bankers' acceptances command the lowest rates of discount. Hence, not only is the exporter's chance of disposing of his bill increased, but the

price he receives for it is higher when it is drawn upon a bank. When a foreign customer instructs an exporter to finance a shipment by drawing upon a designated bank, he is offering especially favorable terms of payment and can expect to receive as a concession a favorable price quotation; thus both buyer and seller in international trade find in the bankers' acceptance a most useful financing instrument.

But an importer who instructs his foreign creditor to draw against a bank for the sale price of the goods must supply his creditor with some evidence that the bank has agreed to accept the draft. It is a prerequisite of the transaction from the point of view of the exporter that no question arise as to the authority under which he places the bank in the position of drawee, for doubt upon this point would debar other bankers from handling the exporter's bill. If the bank upon which the exporter is told to draw is located in his own country, it is not difficult for the exporter to verify his privilege of drawing by communicating with the bank. In this case, the importer who has opened the credit for the benefit of the exporter may simply write the latter that he is to obtain payment for his goods by drawing against this credit, leaving it to the exporter to assure himself of his position before parting with the merchandise. But when the accepting bank is located outside the exporter's country, he must have some guaranty or assurance that the bank is cognizant of the use of its credit and is prepared to honor the draft made upon it. The commercial letter of credit is a document which gives the exporter this assurance.

50. Commercial letter of credit issued by a bank upon itself. The commercial letter of credit is of two types: in its simpler form, it is a written authorization issued by a bank to a client permitting a specified beneficiary to draw drafts for a stated amount upon the bank itself. The second form is somewhat more complex; in this case, the bank issues a letter to a client which authorizes the beneficiary to draw drafts for a stated amount upon another bank, usually located in another country. In the present section we shall discuss the simpler of these forms.

FORM 12. APPLICATION FOR LETTER OF CREDIT (BOSTON BANK)

Boston.....

Boston Bank.

Foreign Department

Import

Division

.....

Boston, Mass.

Dear Sirs:

Please issue an Irrevocable Letter of Credit by ^{cable}mail

For account of.....

In favor of.....

Amount..... available by drafts at.....

against documents as follows:

Bills of lading reading

Bills of Lading

"Received for Shipment" or

Invoice

otherwise worded to same

Consular Invoice

effect are acceptable against

this credit.

covering ^{Full} invoice value C.I.F., C. & F., F.O.B., F.A.S. shipments.
75% (Cross out all but one).....
to be shipped from..... to

Drafts to be negotiated on or before.....

Insurance to be effected by.....

Partial shipments are to be permitted.

Special instructions.....

The letter of credit is subject to your usual terms and conditions, and in consideration of the issuance thereof we agree to reimburse you on demand, and we hereby authorize you to charge our account with any and all amounts for which you are liable thereunder, plus your commission and charges.

Neither you nor your correspondents shall be responsible for the description, quantity, quality or value of the merchandise shipped under this credit, nor for the correctness, genuineness or validity of the documents, nor for delay or deviation from instructions in regard to shipment, nor for any other cause beyond your control.

Very truly yours,

.....

.....

Let us assume, by way of illustration, that the Massachusetts Weaving Company has placed in Japan an order for silk amounting to \$100,000. This company now makes application to its bank in Boston for a letter of credit which will authorize the Japanese exporters to draw a draft or a series of drafts upon the Boston bank, the drafts to run ninety days from acceptance. This application is made on a special form provided by the bank. A specimen of a typical application for a letter of credit is given;¹ the reader is urged to examine this document, and all others which illustrate the text of this chapter with some care, since it is only in this way that the nature of these transactions can be made clear.

If the negotiation for the letter is successful, the bank will ask the company to sign a document called *a contract for the purchase of a letter of credit*, setting forth the terms upon which the letter is granted. A specimen of this contract is given;² examination shows that it contains the following principal provisions:

- (1) The Weaving Company, in the first paragraph, binds itself to provide the Boston bank with funds to redeem each bill drawn under the authority of the letter of credit, before the maturity of the bill.
- (2) It is agreed that the merchandise imported by the company shall be the property of the bank, until all obligations of the company to the bank have been discharged. This merchandise is to be insured by the company for the benefit of the bank. It is to be held subject to seizure and sale by the bank, the proceeds to be applied to the redemption of the bank's acceptances and the payment of any expenses incurred. Seizure, however, does not release the company from its obligation to make good any deficiency in the proceeds realized from the sale to discharge the company's obligations at the bank.
- (3) Under certain conditions (such as a falling market for the merchandise) the bank is authorized to demand additional collateral security from the company, with

¹ See Form 12, page 207.

² See Form 13, page 210.

power to seize the goods if the additional collateral is not supplied.

- (4) All obligations of the company to the bank are to become due and payable in event of insolvency by the company.
- (5) Provision is made for the release of the shipping documents in advance of payment under a trust receipt, with the understanding that the company shall support the trust receipt by depositing collateral.
- (6) The commission charges of the bank for its service and other miscellaneous matters are covered by the contract.
- (7) Finally, the bank in an important clause waives all obligation to guarantee the goods in any respect or their date of shipment. The Japanese exporters may send silk of a poorer quality than that purchased, or may send short weight, or fail to deliver according to agreement, but none of these contingencies shall alter the obligations of the Weaving Company to the bank. It is important to bear this fact in mind, for it materially affects the usefulness of letters of credit to importers. In essence, the effect of the contract upon the company is to compel it to pay the specified amounts, regardless of the behavior of the Japanese exporters, provided the latter draw their bills in proper order and at the proper time.

When this contract has been drawn up and signed, the Boston bank issues a letter of credit naming the Japanese exporters as beneficiaries. Under ordinary conditions, this letter will be delivered to the Weaving Company and mailed by them to the exporters in Japan; it may, however, be sent by the bank to the exporters, and, if time is pressing, may be replaced by a cable to the bank's correspondent in Yokohama, instructing the latter to inform the exporters of their right to draw against the Boston bank. Cabling charges, of course, will be borne by the Weaving Company. A copy of a typical letter of credit, issued by an American bank upon itself, is

FORM 13

CONTRACT FOR THE PURCHASE OF DOLLAR IMPORT LETTER OF CREDIT

Boston

To the Boston Bank.

Dear Sirs:

Having received from you the Letter of Credit No., we hereby agree to its terms, and in consideration thereof we agree with you to provide in Boston, on the day previous to the maturity of the bills drawn in virtue thereof, sufficient funds in cash, to meet the payment of the same with per cent commission, and we undertake to insure at our expense for your benefit, against risk of Fire or Sea, all property purchased or shipped pursuant to said Letter of Credit in companies satisfactory to you.

We agree that the title to all property which shall be purchased or shipped under said Credit, the Bills of Lading thereof, the Policies of Insurance thereon, and the whole of the proceeds thereof, shall be and remain in you until the payment of the bills referred to and of all sums that may be due or may become due on said bills or otherwise, and until the payment of any and all other indebtedness and liability now existing or hereafter created or incurred by us to you on any and all other transactions now or hereafter had with you, with authority to take possession of the same and to dispose of them at your discretion for your reimbursement as aforesaid, at public or private sale, without demand or notice, and to charge all expenses, including commission for sale and guarantee.

Should the market value of said merchandise in Boston, either before or after its arrival, fall so that the net proceeds thereof (all expenses, freight, duties, etc., being deducted) would be insufficient to cover your advances thereagainst with commission and interest, we further agree to give you on demand any further security you may require, and in default of same you shall be entitled to sell said merchandise forthwith, or to sell "to arrive," irrespective of the maturity of the acceptances under this Credit, we being held responsible to you for any deficit which we bind and oblige ourselves to pay you in cash on demand.

In case we should hereafter desire to have this Credit confirmed, altered or extended by cable (which will be at our expense and risk) we hereby agree to hold you harmless and free from responsibility from errors in cabling, whether on the part of yourselves or your Agents, here or elsewhere, or on the part of the cable companies.

This obligation is to continue in force, and to be applicable to all transactions, notwithstanding any change in the composition of the firm or firms, parties to this contract or in the user of this Credit, whether such change shall arise from the accession of one or more new partners, or from the death or secession of any partner or partners.

It is understood and agreed that if the documents representing the property for which this Credit has been issued are surrendered under a trust receipt, collateral security satisfactory to the BOSTON BANK, such as stocks, bonds, warehouse receipts, or other security shall be given to the Trust Company, to be held until the terms of the credit have been fully satisfied and subject in every respect to the conditions of this agreement.

It is further agreed and understood in the event of any suspension, or failure, or assignment for the benefit of creditors on our part, or of the nonpayment at maturity of any acceptance made by us, or of any indebtedness or liability on our part to you, all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon, at your option then or thereafter exercised, without notice mature and become due and payable.

It is understood and agreed that you and your correspondents shall not be held responsible for the correctness or validity of the documents representing shipment or shipments, nor for the description, quantities, quality or value of the merchandise declared therein.

.....

given;¹ it will be seen that the principal features are the following:

- (1) In the body of the letter the Japanese exporters are formally notified of their right to draw against the Boston bank for a total of \$100,000. Instructions are given regarding the form of the drafts and the documents which must accompany them. The shipping documents are the same as those described in the preceding chapter — bill of lading, invoices, and insurance policy. Each draft must bear on its face evidence that it was drawn under the letter of credit. These prescriptions must be carefully observed by the Japanese exporters, for no banker will negotiate bills under the authority of the letter of credit which do not in every detail conform to the regulations laid down by the letter.
- (2) The rest of the letter is addressed to foreign bankers who are asked to buy the bills drawn under the letter. The Boston bank formally obligates itself to honor all drafts drawn to conform to the terms of the letter, if drawn before a certain date. Negotiating bankers are instructed to endorse on the back of the letter the amount of each draft and the date of negotiation, and to send directly to the Boston bank a copy of the bill of lading and the consular invoice which is attached to the draft.

With this authorization in hand, the Japanese exporters can ship the silk either in one or a number of lots, drawing for the value of each shipment against the Boston bank. To each draft is attached the bill of lading and other required documents and the resulting documentary commercial bill is offered for sale to a Japanese banker, the letter of credit serving as an assurance to the banker that the transaction is *bona fide*. Since the draft, when it reaches Boston, will become a banker's acceptance and hence a credit instrument of high grade, the Japanese bank will not hesitate to buy it outright, paying the exporters in Japanese money the value of the silk they have shipped. The bill is then sent by the purchaser to

¹ See Form 14, page 212.

FOREIGN EXCHANGE

FORM 14. IMPORT LETTER OF CREDIT (DOLLARS)

Credit No. 100

BOSTON BANK
Foreign Department

For \$100,000 — U.S.C.

Boston July 1, 1921

Japanese Exporters

Yokohama, Japan

Dear Sirs:

At the request of Massachusetts Weaving Company we hereby authorize you to value on BOSTON BANK, Boston, Mass., by your drafts at three (3) months sight for any sum or sums not exceeding a total of one hundred thousand dollars accompanied by commercial invoice, consular invoice, bills of lading representing shipment of raw silk from Yokohama to Boston

Insurance marine, to be effected by shippers

Bills of lading for such shipments must be drawn to the order of the Boston Bank of Boston unless otherwise specified in this credit.

A COPY OF THE CONSULAR INVOICE AND ONE BILL OF LADING MUST BE SENT BY THE BANK OR BANKER NEGOTIATING DRAFTS, DIRECT TO THE BOSTON BANK, BOSTON, U.S.A.

THE AMOUNT OF EACH DRAFT NEGOTIATED TOGETHER WITH THE DATE OF NEGOTIATION MUST BE ENDORSED HEREON.

We hereby agree with bona fide holders that all drafts drawn by virtue of this credit, and in accordance with the above stipulated terms, shall be honored upon presentation at the Boston Bank if drawn and negotiated on or before October 1, 1921

N.B. All drafts drawn under this credit BOSTON BANK

must bear clause "drawn under Boston Bank Letter of Credit No. 100

dated Boston July 1, 1921 to

cover shipment of Raw Silk from

Yokohama to Boston

a correspondent bank in Boston to be presented for acceptance to the Boston bank upon which it is drawn; it will allow delivery of the documents against acceptance. When presentment is made, the Boston bank will examine the documents to see that they conform to the requirements of the letter of credit; if satisfied upon this point, it will accept the draft and return it to the presenting banker, detaching and retaining the documents. The transaction then divides into two parts. The bill of exchange is now held in Boston for the account of the Japanese bank; being a banker's acceptance of ninety days' usance, it may be sold in the discount market, thus recovering for its owner the money invested in it. We need not now inquire into the motives which induce a Japanese bank to create such funds in Boston, nor into the uses to which it intends to put the proceeds of the sale of the acceptance. The acceptance will find its way into the hands of some investor in the discount market, where it will remain until maturity, when it will be presented to the Boston bank for redemption. By the terms of the contract for the letter of credit, the Weaving Company is bound to deposit with the bank funds sufficient to redeem the acceptance some days before the date of maturity.

The second phase of the transaction concerns the relations of the Weaving Company with the bank. The bill of lading and other documents were retained by the bank when the draft was accepted. In due course, the silk will arrive in the harbor, and the Weaving Company will wish to make some arrangement by means of which it can obtain possession of the goods. In extreme cases, it may find itself unable to make any arrangement more satisfactory than a cash prepayment of the acceptance; but this method is not very practicable where the acceptance has been sold in the discount market and its present owner is unknown. Moreover, unless the company's credit is unusually poor, the bank will give up the bill of lading under the protection of a trust receipt. The surrender of merchandise collateral against a trust receipt is a common practice with American banks, a practice which contrasts with the attitude of suspicion taken toward the method

by the banks of England and other countries. The trust receipt, to be adaptable to the purposes of the company, must be drawn in such form as to allow the goods to be processed and sold while in the company's possession; a copy of such a trust receipt is given on page 182; it provides for the treatment of the goods, and their sale, by the company, at the same time continuing the ownership in them by the bank, and obligating the company to turn over all proceeds of their sale to be applied against its debt to the bank. Whether or not the company completes its sale of the silk, it is bound by the contract to cover the draft before it falls due, and this obligation it cannot avoid otherwise than by declaring itself insolvent.

In recent years, the proportion of our import trade financed by the type of letter of credit just described has been increasing rapidly, as a result of the Great War and of the development of the banking structure of the United States. It is impossible to say with assurance whether this type of letter will become, in the future, a customary financing instrument among American importers, but certain conditions may be laid down as governing the extension of its use. It will become apparent, when reflecting upon the motives which determine the choice of financing instruments by merchants, that letters of credit issued by our banks upon themselves will be used only within the limits set by the salability of dollar bills to the bankers in foreign centers. Exporters of silk from Japan, to revert to our illustration, will certainly wish to draw bills which Japanese bankers are ready to buy; a letter of credit issued by an American bank upon itself will result in the drawing of long dollar bills, and these, when bought by Japanese bankers, will result in the accumulation of funds in American money centers. The willingness of Japanese and other foreign bankers to buy these bills from their clients will depend upon a number of factors, chief among which are: first, the perfection of the discount market in American as compared with London and other centers, for ability to discount the bill is an essential condition to the banker's purchase; second, the opportunities which these

bankers have of utilizing funds in American cities — that is to say, the demand in their market for bankers' drafts drawn in dollars. Given marketability of dollar drafts equal to that of drafts in other moneys, foreign exporters will still refuse to draw them unless they can be sold at favorable prices, and this matter will be determined by the discount rate in the open money markets of America as compared with the rates in other centers. Under the conditions which long obtained before the Great War, these long dollar bills drawn on American bankers were not used. The premier place among financing instruments in foreign trade was held by sterling exchange; these could be sold everywhere and at the most favorable rates. When conditions are again normal, it may be found that most of the letters of credit issued to American importers call for the drawing of drafts, not against the issuing bank in America, but against some bank in London. We shall now turn to a description of such a letter.

51. Letter of credit issued upon a second bank. The essentials of the transaction we are about to consider are these: the clients of an American bank require power to instruct foreign exporters to draw against a banking house in London; the American bank can bestow this power, provided it has previously received the London bank's agreement to accept the drafts drawn. Accordingly, we separate the operations involved in the issue of a letter of credit by an American bank upon an English bank into three phases:

- (a) The arranging of terms between the two banks which bind the English bank to accept drafts drawn in pounds sterling under the authority of a letter of credit to be issued by the American bank.
 - (b) The agreement between the American importer and the American bank concerning the terms upon which the latter will exercise its power to issue to the former a letter of credit against the bank in London.
 - (c) The drawing of sterling bills by the foreign exporter and the handling of these bills in the exchange markets.
- (a) *The acceptance agreement between the two banks.* The banks in question will be correspondents, the one located in

London, the other in America; the arrangement between them concerning the letter of credit will involve the establishment and maintenance of an acceptance account by the London bank in favor of the American. All acceptances performed by the London bank will be charged immediately to this account, and all maturities, when redeemed out of the cash balance which the American bank maintains with its London correspondent, will be removed from the acceptance account. At any moment, therefore, the acceptance account will show the total of the bills outstanding and the dates upon which they will mature. The American bank is bound by the agreement to deposit funds for the redemption of every acceptance, for it is not the intention of the London bank to expend any of its own cash in connection with the transactions which arise under the letter of credit, but only to lend its credit, or, in other words, the use of its name as acceptor, with the understanding that all payments will be borne by the American correspondent.

It should be apparent, however, that the London bank cannot open an acceptance account without some risk to itself. In the eyes of the law, all acceptances which it makes are binding liabilities, in no way contingent upon the performance by the American bank of its part of the contract; upon maturity, they will be presented to the acceptor for redemption and redemption cannot be postponed without acknowledgment of insolvency by the London bank. This risk is so great that the American bank can properly be required to secure its London correspondent against loss, and so the acceptance account is usually hedged about by two restrictions: (1) a maximum amount is established and the American bank is debarred from granting credits in excess of this amount; (2) collateral security equal to the value of this maximum credit is placed in the hands of the London bank to be used whenever the cash balance of the American correspondent is insufficient to redeem any acceptances when they mature. Exceptions to these rules are not lacking. Banks whose associations have been of long standing and free from all evidence of bad faith will sometimes create acceptance accounts to

which no formal restrictions apply, the American bank being left free to issue letters of credit to any amount within reason, without the deposit of collateral of any kind. But such cases are rare; the London bank in undertaking to accept drafts under powers granted by the American bank is bearing the risk, not only of bad faith, but of business reverses which may cause the failure of the American bank while some of the acceptances are outstanding.

The London bank will charge a commission for the service it renders as acceptor. This commission varies rather widely as between different correspondents, being based somewhat upon the volume of business of other kinds which the American bank provides, the amount of cash it customarily keeps on deposit, and, in general, the profit which the London bank can derive from the position of correspondent. In any case, the scale of rates will be adjusted to the length of life of the drafts which are drawn under the letter of credit. The following is a typical system of commission charges:

CHARGES OF LONDON BANKS FOR ACCEPTING STERLING DRAFTS
UNDER LETTER OF CREDIT

	<i>per cent</i>
Sight drafts.....	1/8 to 1/4
30 days' sight.....	1/4 to 3/8
60 days' sight.....	3/8 to 1/2
90 days' sight.....	1/2 to 5/8
4 months.....	5/8 to 7/8
6 months.....	7/8 to 1

This proportioning of the commission charges to the usance of the draft is accounted for by the fact mentioned above; namely that in accepting a draft for the account of a correspondent, the London bank is venturing its credit against the chance of failure by the American bank before the draft matures. The longer the lapse of time between acceptance and maturity, the greater the chance that some calamity will intervene to prevent the American bank from performing its obligation to supply the acceptor with funds for redemption. The rising scale of commission charges is, therefore, a measure of the increasing risk which the acceptor bears.

FORM 15. STERLING IMPORT LETTER OF CREDIT AGREEMENT

Boston.....

To the

BOSTON BANK

Gentlemen:

Letter of credit having been issued at my/our request, I/we hereby agree to its terms, and in consideration thereof, I/we agree with you to provide in Boston, at such time previous to the Maturity of the Bills drawn in virtue thereof, as may be decided by you, sufficient funds in cash, or in Bills on London, satisfactory to you and endorsed by me/us to meet the payment of the same with.....

.... per cent commission and interest as hereinafter provided, and I/we undertake to insure at my/our expense, for your benefit, against risk of fire or sea, all property purchased or shipped pursuant to said Letter of Credit, in companies satisfactory to you.

I/we agree that the title to all property which shall be purchased or shipped under the said credit, the bills of lading thereof, the policies of insurance thereon and the whole of the proceeds thereof, shall be and remain in you until the payment of the bills referred to and of all sums that may be due or that may become due on said bills or, otherwise, and until the payment of any and all liabilities and indebtedness now existing or now or hereafter created or incurred by me/us to you on any and all other transactions now or hereafter had with you, with authority to take possession of the same and to dispose thereof at your discretion for your reimbursement as aforesaid, at public or private sale, without demand or notice, and to charge all expenses, including commission for sale and guarantee.

Should the market value of said merchandise in Boston, either before or after its arrival fall so that the net proceeds thereof (all expenses, freights, duties, etc., being deducted) would be insufficient to cover your advances thereagainst with commission and interest I/we further agree to give you on demand any further security you may require, and in default thereof you shall be entitled to sell said merchandise forthwith, or to sell "to arrive" irrespective of the maturity of the acceptances under this credit, I/we being responsible to you for any deficit, which I/we bind and oblige myself/ourselves to pay you in cash on demand.

It is understood that in all payments made by me/us to you in the

United States, the Pound Sterling shall be calculated at the current rate of exchange for Bankers' bills in Boston on London existing at the time of settlement, and that interest, if any, shall be charged at the rate for overdrafts current in London, at the time of settlement.

Should I/we anticipate the payment of any portion of the amount payable, interest is to be allowed at a rate to be fixed by you.

In case I/we should hereafter desire to have this credit confirmed or extended by cable (which will be at my/our expense and risk), I/we hereby agree to hold you harmless and free from responsibility from all errors in cabling, whether on the part of yourselves or your agents, here or elsewhere, or on the part of the cable companies.

This obligation is to continue in force, and to be applicable to all transactions, notwithstanding any change in the composition of the firm or firms, parties to this contract, or in the user of this credit, whether such change shall arise from the accession of one or more new partners, or from the death or secession of any partner or partners.

It is understood that if the documents representing the property for which the said credit has been issued are surrendered under a trust receipt, collateral security satisfactory to the Boston Bank, such as stocks, bonds, warehouse receipts or other security, shall be given to the Bank to be held until the terms of the credit have been fully satisfied and subject in every respect to the conditions of this agreement.

It is further understood in the event of any suspension, or failure, or assignment for the benefit of creditors on my/our part, or of the nonpayment at maturity of any acceptances made by me/us, or of the nonfulfillment of any obligation under said credit or under any other credit issued by the Boston Bank on my/our account, or of any indebtedness or liability on my/our part to you, all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon, at your option, then or thereafter exercised, without notice, mature and become due and payable.

It is understood that you and your correspondents shall not be held responsible for the correctness or validity of the documents representing shipment or shipments, nor for the description, quantities or quality of the merchandise declared therein.

.....
.....

(b) *Conditions of sale of the letter of credit.* The terms upon which an acceptance account is established with a London correspondent have just been described; they may be summed up in the statement that the American bank promises to redeem all sterling bills charged to the acceptance account, usually supporting its promise by a deposit of collateral security; and agrees to pay a certain commission charge for the services of the London bank. In issuing a letter of credit to a client, the American bank will virtually assign a portion of its power to draw sterling bills, without, however, diminishing its own liability under the terms of the acceptance agreement. We may expect, therefore, that the letter will not be issued until the client has acceded to terms at least as stringent as those demanded of the bank by its London correspondent, terms which will pass on to the client the obligation to supply funds for the redemption of all drafts drawn, and also the expense of maintaining the acceptance account in London. These terms of sale for the letter of credit will be adjusted to the conditions of each individual transaction and will very naturally differ, as the banker's willingness to grant the credit varies with the standing of the client and the character of the commercial operation to which he intends to devote the power granted him by the banker. When approached with a request for a letter of credit, the banker's first inquiry will be — assuming, of course, that the client is not disqualified by an unfavorable reputation — concerning the details of the transaction which is contemplated, the nature of the goods to be imported, and the prospects for a profitable sale in this country; for the goods will be used as security by the banker and must answer the requirements of collateral security — salability and freedom from the risk of deterioration. Satisfied with the transaction, the banker will require further that the client give assurance of his financial stability, usually by exhibiting a statement of the condition of his business, though this assurance may be taken for granted in the case of business men with whom the banker has had long acquaintance.

If the letter of credit is issued, the client will be called upon to sign a contract similar to the one given.¹ This contract is

¹ See Form 15, page 218.

in many respects identical with that used when the letter of credit is issued by the bank upon itself; examination discloses the following additional features:

- (1) The funds which the client agrees to supply for the redemption of the acceptances are to be in the form of sterling demand drafts or the equivalent of these drafts in American money. This is because the bank which issues the credit is obliged to cover the London bank's acceptances in sterling demand drafts and it merely passes this obligation on to the client on whose behalf the letter is issued.
- (2) In this contract, it is provided that the client shall have the option of prepaying his obligations and the rate of interest allowed for prepayment is specified. This provision is sometimes included in agreements regarding dollar letters of credit, but did not appear in the specimen used by us in the preceding illustration.

The letter of credit, itself, will be addressed to the foreign exporter apprising him of his power to draw sterling bills of a certain tenor and to a specified amount upon the London bank; the form of these drafts will be prescribed — documentary drafts of the usual type, each bearing upon its face evidence that it was drawn under the letter of credit and for the purpose of financing a specified transaction. The letter, also, will contain clauses for the information of foreign bankers who are called upon to negotiate these drafts, instructing them to endorse the amount of each draft upon the back of the letter, together with the date of negotiation, and to send a copy of the invoice and bills of lading to the Boston bank. Under these conditions, foreign bankers are assured that the drafts will be honored by the British Foreign Bank of London.

It is customary for the exporter, who is to be the beneficiary of the letter of credit, to insist that the letter be irrevocable. An irrevocable letter cannot be recalled when once issued, so long as its terms are observed; accordingly, the exporter, when in possession of an irrevocable letter of credit, may proceed to fill his customer's order for goods even though this requires manufacture or expenditure of money on his part for other

purposes, in the assurance that the credit which has been established in his favor will not suddenly be recalled before he has time to recoup his expenses. In some cases, however, the bank expressly retains the right to revoke the letter, though it can exercise this right only by giving advance notice to the parties concerned and cannot make the revocation retroactive so as to apply to any drafts drawn before the notice of revocation reaches the drawer. Whether irrevocable or not, the letter of credit will hold good only for a definite period of time, the date upon which it becomes void being plainly stated on its face as a warning of this condition to any one to whom it is exhibited. The foregoing description of the letter of credit may be illustrated by a copy of a typical letter which appears on page 223.

The American bank will notify its London correspondent each time a letter of credit is issued against the acceptance account, stating the definitive number of the letter and describing its terms. Up to this point in the transaction, the accepting bank has done nothing to give the exporter, beneficiary of the letter, legal power to enforce the acceptance of drafts drawn upon it. No contract exists between the drawer and this bank; the obligations of the bank lie solely between itself and the American correspondent under the terms of the acceptance agreement. The exporter's only assurance that his drafts will be honored rests upon his possession of the letter of credit, and this, it should be recalled, has been issued, not by the accepting bank, but by the importer's banker in America. Now, although in the practice of international commerce the risk of non-acceptance is slight, whatever risk exists must be borne by the exporter who will be expected to part with his goods in a belief that his drafts will be accepted. If non-acceptance occurs, the exporter will be obliged to return to his banker all funds advanced him on bills of exchange which are returned unaccepted and he must then depend upon action brought against the American bank to recover his loss. It is the privilege of the exporter to refuse to bear this risk, in which case, if the transaction is to take place, the importer must have the letter of credit *confirmed* by the London bank

FORM 16. IMPORT LETTER OF CREDIT (POUNDS STERLING)

Credit No. 100

BOSTON BANK
Foreign Department

For £20,000

Boston July 1, 1921

Japanese Exporters
.....
Yokohama, Japan
.....Dear Sirs:
At the request of Massachusetts Weaving Company
we hereby authorize you to value on

BRITISH FOREIGN BANK, LIMITED, LONDON

by your drafts at three (3) months sight for any sum or sums not exceeding a total of
.....
twenty thousand pounds sterling accompanied by commercial invoice, consular
.....
invoice, bills of lading, representing shipment of
..... raw silk from Yokohama to Boston
Insurance Marine to be effected by the shippers

Bills of lading for such shipments must be drawn to the order of the BOSTON BANK unless otherwise specified in this credit.

A COMMERCIAL INVOICE, CERTIFIED COPY OF THE CONSULAR INVOICE AND ONE BILL OF LADING MUST BE SENT DIRECT TO THE BOSTON BANK, BOSTON, U.S.A., BY THE NEGOTIATING BANK WHOSE CERTIFICATE TO THAT EFFECT TOGETHER WITH THE REMAINING DOCUMENTS MUST ACCOMPANY YOUR DRAFT.

THE AMOUNT OF EACH DRAFT NEGOTIATED TOGETHER WITH THE DATE OF NEGOTIATION MUST BE ENDORSED HEREON.

We agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation at the BRITISH FOREIGN BANK, LIMITED, LONDON, ENGLAND, if drawn and negotiated on or before
October 1, 1921N.B. All drafts drawn under this Credit
must bear the clause "drawn under Boston Bank Letter of Credit No. 100"
.....BOSTON BANK
.....dated July 1, 1921 to
.....
cover shipment of Raw Silkfrom Yokohama
.....
Boston
to

in such manner as to place in the exporter's hand a contract which will bind the London bank to accept all drafts when properly drawn, thus reducing the exporter's, and increasing the bank's, liability. An extra commission will be charged by the accepting bank when a letter of credit is confirmed, and this extra charge will be passed on to the client of the American bank who is buying the letter. A specimen of a typical letter of confirmation is given below:

BRITISH FOREIGN BANK, LIMITED

IRREVOCABLE EXPORT

London, July 11, 1921

CREDIT No....

EXPIRING October 1, 1921

Japanese Exporters

Yokohama, Japan.

You are hereby authorized to draw upon us for

Account of Mass. Weaving Company

To the extent of not exceeding £20,000

Covering shipments of raw silk

Bills of lading issued by forwarding agents will not be accepted unless specifically authorized herein, and any modification of the terms of the credit must be in writing over authorized signature of this Bank.

Drawings must clearly specify the number of this credit.

Yours truly,

.....Manager Foreign Department.

This confirmation is an *irrevocable contract* during the term of life stated upon it. If the issue of the letter of credit is intended to be revocable at the option of the American bank, this fact will be disclosed by the absence of the word "Irrevocable" at the top of the letter and the inclusion of a statement reserving to the bank the right to recall the credit upon due notice to the exporter. Sometimes, an accepting bank wishes to inform the beneficiary of a letter of credit that the credit has been established with its permission and yet to

avoid granting a contract of acceptance: this may be done by including in its letter to the exporter some such words as the following, "This letter is for your guidance in preparing the documents and conveys no engagement on the part of this bank." The *confirmed, irrevocable credit*, however, is the rule in international commerce.

(c) *Drawing and handling bills under a letter of credit.* We have now reached the third phase of the operations involved in the use of a letter of credit issued by one bank upon another; in discussing the processes involved in the drawing of bills under the authority of the letter, we shall best proceed by means of an illustration. Assume, then, that the Japanese exporters of silk, in the illustration used earlier in this chapter, had required the Massachusetts Weaving Company to establish in their favor a confirmed irrevocable sterling credit for the total of twenty thousand pounds. The company will sign a contract with the Boston bank for the purchase of such a letter, will receive the letter and send it to the exporters in Japan. The transactions at that end will proceed much as before, the exporters drawing in sterling instead of in dollars as shipments are made. The letter of credit will be shown by them to their bankers as evidence of their right to draw and this evidence will be sufficient, in case the drafts are in the prescribed form and accompanied by the prescribed documents, to command a ready market for their bills. If the total credit is exhausted at one drawing, the letter of credit will be taken up by the Japanese bank and added to the other documents; if not, each drawing will be endorsed upon the reverse side of the letter and a subtraction made so as to set forth clearly the amount of credit remaining, and with the last drawing the letter will be surrendered and attached to the draft.

Like all long bills, these must be sent for presentment to the drawee. Accordingly, the Japanese bank will mail them to its London correspondent who will present them for acceptance to the London bank on which they are drawn. This bank will first examine the documents to see that they are in order, and, finding them so, will then accept the drafts, de-

taching and retaining the documents in its own possession. The acceptances will then be discounted in the London market (assuming, of course, that the Japanese bank does not choose to retain them for investment) after which the Japanese bank will have a credit of something less than twenty thousand pounds sterling in London against which it can draw drafts for sale in Yokohama. The bill of lading and other documents retained by the accepting bank will be forwarded to the American correspondent (in this case the Boston bank) with notice of the charge which has been made against the acceptance account. They should reach Boston, under normal conditions, considerably in advance of the silk which has been proceeding by freight from Japan, and the Boston bank will inform the Weaving Company of their arrival. When the silk appears in the harbor, the company will reach some agreement with the bank, usually through the agency of the trust receipt, by means of which it may gain possession of the goods and proceed to dispose of them according to the plans of its business.

In the meantime, the acceptances will lie in the hands of some investor in the London market until maturity, when they will be presented to the accepting bank for redemption. It will be recalled that the redemption of these bills is a legal obligation of the acceptor; that the London bank has bound its Boston correspondent to cover this obligation by the remittance of funds before the acceptances mature, and that the Boston bank has passed this obligation on to its client, the Massachusetts Weaving Company. To place the acceptor in funds for redemption, a remittance of sterling demand drafts must leave Boston seven days before each draft matures, and on the preceding day, or eight days before the term of the draft, the Weaving Company will be bound by its contract to deliver the proper amount of sterling sight bills, or to deposit enough money with the Boston bank to buy these bills at the ruling rate of exchange. Thus the importers of the silk will discharge their obligation under the contract for the letter of credit, in time for the Boston bank to discharge its obligation under the acceptance agreement, in

time for the London bank to meet its acceptances. More simply stated, the Weaving Company will pay for its silk by passing the purchase price through a Boston bank to London where it is used to cancel drafts drawn by the exporters against the shipment. When we bring the two parts of the commercial transaction together, we see that the Japanese exporters are paid cash on delivery from London through a local bank in Yokohama, and that the American importers repay this advance by remittance to London at a later date.

52. **Banking relations involved in letter of credit.** Though in the present chapter we are primarily interested in the commercial aspects of bills of exchange, it may be well at this point to review briefly the banking relations created by the series of transactions just discussed. There are three banks concerned in these transactions: the buying bank in Yokohama, the accepting bank in London, and the remitting bank in Boston. The first and third deal with exporter and importer respectively, while the second acts as a focal point for these two. Now, the salient feature of this operation in foreign exchange is that none of the banks concerned is required to advance funds of its own at any stage of the process, yet the exporters receive the money for their silk long in advance of the payment by the importers. In fact the chief commercial function of the letter of credit is to make it possible for buyers of goods to postpone payment without at the same time demanding that the sellers wait for their money until payment is made, and this function was admirably discharged in the foregoing illustration. The exporters in Japan received the value of their silk as soon as it was on board the steamer; but the importers in America made no payment until some months later. Now, there is no magic in letters of credit; some one must have bridged this gap between the receipt of money in Japan and its payment in America: who was this person? To prepare ourselves for the answer to this question, let us first see that *the advance was not made by any of the three banks concerned.*

At first thought it appears that the burden of advancing the money fell upon the Japanese bank, for it was this insti-

tution which immediately furnished the funds to the exporters. Now, it is true that the Japanese bank could, if it so desired, carry through the transaction in such a way as to bear the burden of the advance, but it is in no wise compelled to do this and only in very rare instances will it choose to do it. In our illustration, each sterling draft bought by this bank was hurried to London for acceptance through a correspondent in that city. After acceptance, the draft was sold in the discount market and the proceeds carried to the credit of the account of the Japanese bank, thus placing it in position to sell sterling demand drafts in Japan. Every sterling bill bought from the exporters and discounted in London would be tantamount to a transfer of funds from the bank's vaults to the vaults of its London correspondent; but, on the other hand, every sterling draft sold against this credit would reverse the transfer and replace the funds in the bank's vaults. Now, the transaction we are considering can cause an advance payment by the Japanese bank only if its receipts from the sale of sterling demand drafts lag behind its expenditure in the purchase of sterling commercial bills drawn under the letter of credit, and no lag need occur. The demand drafts may be sold on the same day the commercial bills are bought; both will consume exactly the same amount of time in reaching London, and, arriving there simultaneously, will offset each other. If the Japanese bank is regularly engaged in foreign exchange dealings, it may be assumed as a fundamental rule that every purchase of sterling bills is counterbalanced by an immediate sale.

In one case, only, will the burden of the advance fall upon the Japanese banker, namely, if he choose to instruct his London correspondent not to sell the acceptance in the money market, but to hold it to maturity. When he buys the sterling commercial bill, the banker in Yokohama will discount the face amount for the length of time the bill is to run; if, now, the bill is held in London until maturity, and then presented to the accepting bank for redemption, the banker who bought it will get back more money than it cost — in other words, he will earn interest on the funds invested in the pur-

chase price. But, in this case, he will also be estopped from selling sterling demand drafts upon the day he buys the bill, for he will have no funds in London for the redemption of the demand drafts until some months later. He is forced to wait for the recovery of his funds and, as a remuneration for this waiting, receives interest earned by the acceptance while it is lying in the hands of his London correspondent. We must emphasize the point, however, that this burden of waiting is not forced upon the banker as an essential element in his transaction, and repeat what was said above, that *as a rule*, he will sell sterling demand drafts as rapidly as he buys sterling commercial bills, and thus make no advance of money at all. Why, then, should he engage in foreign exchange transactions; do not his operations amount to taking money out of one pocket and replacing it in another? He engages in this business to win a *profit* and not to earn *interest*, and his profit is derived from selling demand drafts at a higher rate than he pays for commercial bills. Thus, though his purchases and sales amount to taking from one pocket and returning to another, he is constantly putting back more than he takes out and thus has sufficient inducement to continue in business.

Having seen that the Japanese banker does not advance the money paid to the exporters of the silk, it can be shown in much shorter compass that neither of the other two banks makes this advance. The accepting bank in London merely lends its name, paying out no money until the maturity of the acceptances and, then, merely delivering funds placed in its hands by the Boston correspondent. In the same manner, it is apparent that the Boston bank makes no advance payment, nor, indeed, any payment at all out of its own funds; for the importers of the silk will have discharged their obligation under the contract for the purchase of the letter of credit before the Boston bank is called upon to make a remittance to London. The advance is measured by the length of time which elapses between the receipt by the exporters of the purchase price of the silk and the payment of this price by the importers. This interval is roughly equal to the life of the draft which is used to finance the sale; who-

ever it is that buys this draft and holds it to maturity, he will be the real financier of the transaction, in the sense that it will be he who parts with money to satisfy the sellers and agrees to wait for the recovery of this money until the buyers make payment. This person is usually some one in the discount market of London who, with money to lend, buys the acceptance and holds it to maturity. He will be in no way concerned with the purchase and sale of the silk, nor with any other commercial aspect of the transaction; for he will buy the acceptance solely on the strength of the banker's name which it bears. A true money-lender, he; yet without his knowledge the funds which he brings to the discount market of London will prove a vital agent in a commercial transaction involving markets many thousands of miles removed from his. At this place we may stress the point that it has been largely due to the presence of many such money-lenders in the London market, whose presence assures the buyers of sterling long bills the world over of a broad and stable demand for these bills after acceptance, that the sterling letter of credit has proved so well adapted to the uses of exporters in the world's principal markets.

53. Superiorities of the commercial letter of credit. The perfection of the letter of credit as a device for financing international transactions has been of immense service to the business men of the world who engage in foreign trade. From the point of view of the exporter, a confirmed credit offers the following advantages:

- (a) As has been stated above, it gives rise to a bill of exchange more easily sold than an ordinary trade bill, and one which commands a more favorable and stable rate of exchange. This either increases the exporter's profit, or enables him to quote a lower price for his goods, thus increasing their selling power.
- (b) By virtue of the salability of his drafts, the letter of credit resolves his transaction into a cash sale, and this without exacting onerous terms from his foreign customers. Freight shipments in international commerce are time-consuming; long credit terms are practically

unavoidable if goods are to move freely from seller to buyer between markets far removed from each other. The letter of credit enables the exporter to offer such terms to those of his customers who are in position to provide the confirmed credit, without himself bearing the credit burden.

- (c) Many times goods must be made especially to suit the requirements of the importer's market. This often demands of the exporter the institution of special processes of manufacture, or the adaptation of his plant to cater to foreign tastes; and even if this is not true, the filling of an order compels the exporter to set aside labor and capital and to incur expenses which might be devoted to other ends. When the process of making the goods must be begun some time before the goods are ready to ship, exporters will very naturally be reluctant to incur this expense unless assured that the order will not be cancelled at some time prior to shipment. An irrevocable letter of credit gives them this assurance, for such a credit once established in their favor cannot be recalled by the foreign buyer so long as the exporter can show the documents required by the letter. The perfection of commerce between nations depends upon the development of such confidence.
- (d) When an exporter draws an ordinary commercial long bill, his liability as drawer does not end until payment has been made at maturity. Though the transaction may appear to be a sale for cash when the bill is sold at the time of shipment, it is in reality based, in part, upon the credit of the exporter, and this credit element will eventually be brought home sharply to any merchant who employs such bills on a considerable scale by loss through dishonor on the part of some customer. Even if the exporter's experience is entirely free from losses, however, the employment of the commercial bill is none the less a strain upon his credit; for the number of these bills which he can negotiate at any time with his banker is proportioned to his capital assets, the banker

quite naturally requiring that his contingent liability be supported by adequate capital. Thus, whether the exporter succeeds in selling his trade bills outright, or must content himself with depositing them for collection (and the latter is usually the experience of exporters), his foreign business will drain his credit and restrict the range of operations he can carry on with a given capital. The bill drawn under a confirmed credit differs from the ordinary documentary bill in that, once negotiated with a banker, the responsibility is shifted immediately upon the issuing bank and the exporter's liability ceases.

- (e) An additional advantage of the letter of credit from the exporter's standpoint is to be found in the fact that it frees him from all risk of a falling market and possible repudiation of the goods by his foreign customer. If prices in the importer's country have slumped between the time of sale and the time of delivery, he may be tempted to refuse acceptance of the goods; under such conditions, if the sale is financed by a documentary bill, the importer will also, in all probability, dishonor the draft drawn against the shipment which he has refused to accept. Then the exporter will be put to the trouble and expense of disposing of the goods as best he can and bringing action against the defaulting buyer. However, when the importer supplies the exporter with a letter of credit, one of the terms of his agreement with the bank which issues the letter is that repudiation of the goods will in no wise diminish his obligation to make good all drafts drawn under the letter. No disturbance of the importer's market, nor even insolvency of the importer, can destroy the exporter's market for his bills; accordingly, he can enter into long-term contracts for the shipment of goods, free from all risk of a falling market or of repudiation by the buyer.

The advantages of the confirmed credit to the importer may, to a large extent, be inferred from the preceding discussion.

- (a) He can usually obtain better terms from the seller than would be quoted if a credit were not established. This price concession is no burden on the exporter, since the sale price of his drafts will be proportionately large.
- (b) He can, without difficulty, induce foreign producers to undertake long-term contracts whose performance requires special processes of manufacture, or large initial outlays. At the same time, he can control the performance of the contract within a set time by adjusting the date upon which the credit will expire, and by requiring certificates of inspection among the documents, thus assuring himself that the goods will be shipped as they are needed, and will be up to standard.
- (c) The credit can be varied in different ways to conform to his business needs. The term of the drafts can be long or short accordingly as his projects for disposing of the importation vary; the amount of the drafts may be limited to a proportion of the invoice price as a protection against bad faith on the part of the exporter.

It should be pointed out, however, that the bank which grants the letter of credit waives all obligation to guarantee the goods either as to quantity or quality, and that the importer agrees to this condition. Even flagrant violation of the contract by the exporter does not clear the importer of his duty to pay the amount agreed upon in his contract with the bank, so long as the bills of exchange are properly drawn. Importers have occasionally been defrauded in the most palpable fashion by short shipment, or shipment of bad quality, and have discovered to their surprise and grief that proof of fraud does not suffice to cancel the credit. Bankers attempt to make this matter clear at the time the letter of credit is issued, but do not always succeed. What appears an injustice to the importer, who is compelled to pay for useless goods, is from the point of view of the banks the only defensible business policy. They cannot involve themselves in commercial undertakings to the extent of guaranteeing the goods. All commercial risks must be borne by the parties to the commercial transaction; and, when a letter of credit

is used as the financing instrument, these risks are taken from the exporter and placed solely on the importer. The latter must not only bear the risk of bad faith on the part of his foreign client, but also, as explained above, the risk of a falling market and a losing venture within his own business area.

54. Travelers' letters of credit. The letters of credit thus far described were used to finance business transactions and were, for that reason, called *commercial letters*. All importations of goods have substantially the same effect upon the exchange market, regardless of the form of bill of exchange called for by the terms of sale; this effect is to increase the demand for foreign bills of exchange in the importing market. When a letter of credit is used as the financing instrument, this demand for bills of exchange does not arise at the time the goods enter the country, nor are the bills demanded necessarily drawn upon the country from which the goods come; but, eventually, the importing merchant is forced to enter the market as a buyer of some kind of exchange to an amount equal to the value of his importation. The same effect upon the exchange market is produced by non-commercial transactions between nations, transactions which usually involve the supplying of services by one country to another. Some of these non-commercial transactions are also commonly financed by letters of credit; this is especially true of the services rendered American travelers by foreign hotels, theatres, art galleries, etc. The traveler's letter of credit has come into favor as an agent for financing these expenditures in foreign countries; it does not greatly differ from the commercial letter which we have been discussing, and has the same ultimate effect of increasing the demand for bills of exchange in the United States.

The traveler's letter of credit may take either of the two forms in which commercial letters are issued; that is to say, it may be drawn upon the issuing bank or upon another bank, usually located in a different country. The sterling letter, however, is in wide use among American tourists. A copy of such a letter appears on page 235. The traveler, before leaving the country, goes to his banker and buys a letter

FORM 17. TRAVELER'S STERLING LETTER OF CREDIT

GUARANTY TRUST COMPANY OF NEW YORK

Circular Letter of Credit

No.....

New York,.....

Gentlemen:

We beg to introduce to you and to commend to your courtesies,
 in whose favor
 we have opened a credit of
 Pounds Sterling, and whose drafts to that extent at sight upon the

GUARANTY TRUST COMPANY OF NEW YORK, LONDON

we engage shall meet with due honor of negotiation within.....
 months from this date.

The amount of each payment must be endorsed on this letter
 and your negotiation of the drafts will be considered a guarantee
 that the requisite endorsements have been made.

You will please observe that all such drafts be marked as "Drawn
 against the Guaranty Trust Company of New York Letter of Credit
 No....."

This letter must be attached to the last draft drawn..

We remain, Dear Sirs,

Signature of

Yours faithfully,

.....

.....

vice president

.....

secretary

To Messieurs Our Correspondents.

addressed to all correspondents of the London bank against which the letter is drawn, requesting these correspondents to honor the sterling drafts of the traveler up to the amount stated in the letter. At the same time, the London bank is told that the credit has been established in the traveler's favor, and this bank is prepared to charge the balance of the American bank with the drafts as rapidly as they come in. As funds are needed by the traveler, the letter is presented to any one of a list of foreign banks whose names and addresses are printed upon its face, and sterling drafts of the required size are drawn. The letter serves as evidence of the traveler's right to draw, and, as a check against forgery, it bears a specimen of the traveler's signature. These drafts are all drawn for sight payment and are negotiated at the sterling sight rate of the market in which they are bought. The amount of each one will be endorsed upon the reverse side of the letter and a subtraction will be made, setting forth the extent of the credit remaining. If the total credit is exhausted, the letter will be taken up by the banker who buys the final drafts and sent to the London correspondent; if it is not exhausted, the traveler will receive a refund from the American bank equivalent to the unused portion of the credit.

When selling a traveler's letter of credit, the American bank usually demands in advance a price in dollars equal to the total credit computed at the ruling sight rate for sterling exchange plus any commission charge which it may choose to make. It then has in hand funds sufficient to buy sight drafts on London to cover the total charge which can be made against its balance in that city, and may straightway strengthen the balance by sending over the required amount of sterling exchange. On the other hand, it may choose to make the remittance later as the traveler's drafts find their way into the hands of its London correspondent; but in so doing, it will obviously run the risk of a rising rate of sterling exchange. Whether the remittance is made at the time the letter is sold or at a later date, the American bank will be forced into the exchange market of this country as a buyer of sterling bills with which to repair its London balance; thus

the purchase of foreign services by American travelers, like all other importations, has the final effect of increasing the demand for foreign bills of exchange in our market. It is true that the effect may not be so simple and direct as it is assumed to be in the foregoing analysis. Frequently, American banks buy exporters' bills in amounts large enough to create foreign balances of sufficient size to meet the demand of our tourists and so are not compelled to buy additional sterling exchange each time travelers' letters of credit are issued. Yet the effect of these letters upon the demand for sterling is virtually the same; they provide the bankers with opportunities to utilize their London credits and so increase their power to buy sterling commercial bills profitably.

A foreign banker who buys the traveler's sterling draft will view it simply as a demand bill of exchange to be cashed in London by his correspondent and added to his balance in that city. It will be his intention to use the proceeds as cover for drafts which he has drawn or will draw against the London correspondent, and will therefore base his buying price upon the rate at which he can sell his own sterling demand drafts, allowing a sufficient margin to afford himself a profit. The traveler must bear the risk of exchange, since the price he pays for his right to draw against London will be governed by the sight rate of the day the letter of credit is bought, while the amount he receives for his drafts will conform to a different rate in another city and at a later day. The risk may work either to his profit or loss, according to the movement of the rate of exchange, though in normal times the fluctuation is rarely great enough to have a material effect upon his costs.

In recent years, and especially since the breakdown of the exchange market following the Great War, the letter of credit issued by the American bank against itself has begun to displace the more complex sterling letter. Obviously, the usefulness of the credit from the point of view of the buyer will be tested by the ease with which he can dispose of the drafts he draws under its authority. Drafts drawn in dollars will serve his purpose only if bankers in all the principal foreign

cities are prepared at all times to buy them, and this is rapidly coming to pass with the spread of American branch banks

FORM 18. TRAVELER'S CHECK IN
DOLLARS

TRAVELER'S CHECK

No 000000

Guaranty Trust Company of New York

140 BROADWAY NEW YORK
CHIEF BANKING OFFICE

IN OTHER COUNTRIES
AT BANKERS BUYING RATE OF EXCHANGE
FOR CHECKS ON NEW YORK

IN UNITED STATES
AT BANKERS BUYING RATE OF EXCHANGE
FOR CHECKS ON NEW YORK

TWENTY DOLLARS

WHEN SIGNED BY THE PERSON WHOSE SIGNATURE APPEARS ABOVE

Guaranty Trust Company of New York

Charles D. Johnson

WILL PAY TO THE ORDER OF

THE HOLDER MUST SIGN HERE IN PRESENCE OF PAYING OFFICER

abroad and the increase in the demand in foreign centers for dollar exchange. The sight drafts drawn against a traveler's dollar letter of credit may be bought by foreign bankers with whom the American bank carries a balance; when this is done, the face of the draft is charged against the balance of the American bank at the rate of exchange used by the foreign banker when the draft was bought. Other bankers, not correspondents of the bank which issues the letter, will negotiate these drafts when confident of their ability to reimburse themselves by drawing and selling their own sight drafts against the American bank.

55. Travelers' checks. These are a variation of the traveler's letter of credit in which the drafts are drawn in dollars for convenient amounts by

the issuing bank and delivered in this form to the traveler. These drafts are made self-identifying by a simple expedient; the purchaser writes his signature in

the upper left-hand corner at the time of purchase, but does not countersign until the time of encashment when a second signature is made in the presence of the person accepting the check. Without the second signature, the checks have no value; with it, their currency in foreign countries is very broad, for they are frequently taken as cash by the hotels, ticket-offices, and shops in the principal cities of the world. In case a check is lost, notification is sent to the issuing bank which stops payment at all its foreign branches and refunds the purchase price under guarantee of indemnity by the traveler in case an illegal encashment is made. Under normal conditions, it was the practice of the issuing bank to stamp upon the face of these checks the rate of exchange at which they would be honored by foreign correspondents, thus freeing the traveler from all risk of exchange; but with the large and fluctuating premium on dollar exchange now (1921) obtaining in European markets, the system of fixed rates has been replaced by one which gives the American traveler the advantage of this premium. The checks are now drawn payable in foreign currency at the best rate ruling for exchange on New York on the day of payment and are charged at this buying rate against the foreign balance of the issuing bank. A copy of the traveler's check is given on the opposite page.

CHAPTER IX

OTHER FORMS OF BANK CREDIT

56. Variations of the bank credit. Bank credits are sufficiently elastic to permit of variation to meet the needs of individual transactions in foreign trade. Although the forms of letters of credit discussed in the preceding chapter are the standards in the financing of international commerce, neither procedure nor form is so rigid that the merchant may not, after negotiation with his banker, fit the credit to the peculiarities of his transaction or the particular requirements of his foreign customer. In some cases, essentially similar to those discussed, the letter of credit is omitted from the transaction. The importer may arrange through his banker to place a credit at the disposal of the exporter in the exporter's own market and simply notify him of the creation of the credit at the time of placing the order for the goods.

To illustrate, a merchant in Buenos Aires ordering goods from a commission house in New York may instruct the New York firm that a certain bank in his city is prepared to honor bills drawn against the shipment, or to pay cash against delivery of the shipping documents without the formality of drawing the bill of exchange. To place this credit in New York, the Argentine merchant must act through his own bank in Buenos Aires and rely upon his banker to create the fund available for the use of the exporter. His relations with the banker in Buenos Aires may be on a cash basis; that is, he may merely deposit at that end the invoice price of the goods, or its equivalent in dollar exchange, and instruct his banker to place the deposit in New York to the credit of the commission house there. Such a transaction, however, would involve no credit element, since the commercial operation would be carried through upon the strength of the importer's cash resources. It would become a credit transaction if the

importer induced his banker to create the fund in New York against the importer's promise to repay at a later date. This might be done by depositing collateral security in the hands of the banker, or by giving him a first lien on the goods about to be imported, or in other ways varying according to the importer's credit rating and his standing with the bank. The cost of the credit to the importer would include the interest charge and the commission of the banker. From the point of view of the exporter, the sale would consist simply of a dispatch of the goods and the collection of the purchase price from a local bank.

These bank credits, which omit the drawing of a formal letter, may be *revolving*, or self-continuing credits. This is the case when the buyer who places the credit at the disposal of the seller forms an agreement with the banks involved whereby the credit, when once used, becomes again available without the formality of concluding another contract. A revolving credit is especially serviceable when the transactions between buyer and seller are continuous and protracted, since it obviates the delay and expense of correspondence, or an exchange of cables, for the purpose of arranging the financing details of each particular transaction. To illustrate, the Argentine importer, who figured in the preceding illustration, places in New York for the benefit of the American shipper, a credit with a maximum limit — say, ten thousand dollars — with the understanding that, as each draft is honored in Buenos Aires, the credit is replenished by its amount. The American exporter makes an initial shipment, let us say, of one thousand dollars value, and draws for that amount. This reduces the remaining credit to nine thousand dollars, until the draft is liquidated by the Argentine importer; a series of such drafts will continue to deplete the credit, but as the drafts mature and are paid a succession of liquidations replenishes the credit and permits continued drawing by the exporter. If the total amount of the credit is exhausted at any time, drawing must cease until some of the outstanding drafts have been honored.

This is but one of many possible forms which the revolving

credit may take. Sometimes the agreement calls for the drawing of a specified sum in a single draft, upon the maturity and redemption of which another draft for the same amount may be drawn. Again, the agreement may prescribe the drawing of a single draft, but permit a second drawing for the same amount without awaiting the redemption of the first, and so on indefinitely. Revolving credits usually carry a time limit beyond which they do not run. At the first dishonor by the drawee, the credit agreement is abrogated and all drafts outstanding become due and payable. The commission charges are based, not upon the maximum amount of the credit authorized, but upon the amounts actually utilized by the drafts of the exporter.

Bank credits, of the kinds just described, may be *confirmed* or *unconfirmed*. In the preceding illustrations, it was assumed that confirmation of the credit was not made by the New York bank; that is, the New York bank did not issue to the exporter anything approaching in nature the letter of credit which would give the exporter a legal right to demand the purchase of his drafts by the bank. When confirmation does not take place — and the New York bank will not confirm the credit unless specifically instructed to do so — the exporter will merely be informed by his foreign customer of the creation of the credit, and must take it upon himself to verify the matter by inquiry at the bank. If confirmation is to be made, it must be demanded at the time the terms of sale are drawn up between the two merchants. The act of confirmation increases the obligations of the New York bank; until this bank has confirmed the credit, its obligation to honor the exporter's bills lies between itself and the bank in Buenos Aires at whose request the credit is established; by confirming the credit, however, the New York bank places in the exporter's hands a document by which it is bound to honor the latter's drafts, if correctly drawn, regardless of any failure on the part of the Argentine bank. For this additional obligation, the New York bank will demand an additional commission, which will be payable by the Argentine importer who takes the initiative in establishing the credit.

OTHER FORMS OF BANK CREDIT

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FORM 19. LETTER CONFIRMING AN IRREVOCABLE CREDIT

FIRST COMMERCIAL BANK OF NEW YORK

New York July 1, 1921

Export Credit No. 100

To American Exporter
New York City

Dear Sirs:

In accordance with mail instructions from Argentine Bank we open an irrevocable credit in your favor for the account of Argentine Importer, Buenos Aires.

Amount \$100,000. One hundred thousand dollars.

Covering shipment of electrical machinery

Drafts under this Letter of Credit are to be drawn at sight on us and are to be accompanied by a

set of shipping documents consisting of:

Shipper's invoices.
Consular invoices, if required.
Marine insurance policies.
Full set of ocean steamer Bills of Lading made out

to order and endorsed in blank

It must be understood that payments under this credit will only be made provided goods are actually on board or loading on the vessel named in the Bills of Lading.

Marine insurance should cover from Warehouse to Warehouse, and not less than ten days after arrival, and also include deviation clause, craft and lighter clause, negligence and/or latent defect clause. Policies reading free from particular average completely must not be tendered without prior arrangement with us.

The documents should be presented whenever possible in time to be forwarded on the steamer carrying the goods.

This Letter of Credit expires on Oct. 1, 1921

If you are unable to comply with the terms as indicated above, please communicate with us promptly and oblige,

First Commercial Bank

In the same manner, the matter of the *revocation* of the credit must be settled by agreement between the two merchants.

The final arrangement regarding these matters of revocation and confirmation of the credit will reflect the bargaining power of buyer and seller in international trade. It is natural for the seller to desire a confirmed, irrevocable credit. Its possession enables him to go about the business of filling the importer's order with confidence, even if this involves incurring costs and forming obligations to purchase goods or raw materials in advance of the importer's payment; for the confirmation of the credit by the American bank will assure the exporter a market for his bills, as long as they are drawn in proper order, even if the foreign buyer should suffer business failure or repudiate his contracts. In other words, the letter of confirmation reduces the exporter's risk to that of failure by the American bank which has undertaken to honor his draft. On the other hand, it is equally natural for the importer to attempt to reduce his financing costs to the minimum. To obtain a confirmed, irrevocable credit will not only add to the commission which he must pay, but will require the pledge of collateral and the fulfillment of other conditions laid down by his banker. A copy of the form used by an American bank to confirm an irrevocable credit is given on page 248; by the substitution of the word "revocable" for "irrevocable," this same letter serves to confirm a credit which may be revoked at the option of importer, or either of the banks. Examination of this letter shows that it very closely resembles a letter of credit issued by the bank upon itself.

57. Acceptance credits established by the exporter. Letters of credit and other bank credits used for financing foreign commerce are usually established at the initiative of the importer in favor of the exporter. This is the normal procedure and will probably prevail again when credit conditions of the world have been reestablished on a sound basis. In some cases, however, it best serves the interests of the two merchants for the exporter to arrange with his own banker the creation of a credit which will place the banker's accept-

ance at his disposal. This method, which was denied American exporters, prior to the passage of the Federal Reserve Act in 1913, because of the illegality of bankers' acceptances and the absence of a discount market in New York, has since that date been increasing in importance, owing to changes in our banking mechanism and the increasing difficulty of financing our export trade through foreign centers. In London, the practice is of long standing. The procedure when the exporter takes the initiative in establishing the credit is as follows: The exporter, who has received an order which he needs aid in financing makes an arrangement with his banker by which the latter agrees to accept his drafts for the value of the goods. The exporter draws upon his foreign customer, as usual, attaches the shipping documents to his bill and delivers the bill to his banker as collateral security; he then draws another draft upon the banker for the same amount as his foreign bill (or a portion of this amount), usually making the term of life of his second draft such that it will not mature until after the foreign bill has been paid. The banker accepts the draft drawn upon him, and returns it to the exporter who offers it for sale in the open market, thus receiving payment for his goods. By the terms of his agreement with his banker, the exporter is bound to deposit funds for the redemption of the banker's acceptances before their maturity.

A copy of the acceptance agreement formed between the exporter and his banker is given on pages 246-47. It will be seen, by examining its terms, that the agreement contains the provisions of a letter of hypothecation, together with some of the essentials of a contract for the purchase of a letter of credit.¹ Thus, as in the letter of hypothecation, the exporter formally transfers to the banker ownership in the foreign bill, the goods and the shipping documents which represent them, giving the banker power to seize and sell the goods if such action is necessary for his protection. This pledge of collateral does not, however, release the exporter from his liability as drawer to indemnify the banker from any loss sus-

¹ For description of these documents see pages 168 and 218.

FORM 20. ACCEPTANCE AGREEMENT

In consideration of the acceptance by THE FIRST COMMERCIAL BANK of my/our draft on it numbered.....dated..... payable.....for.....dollars and all other drafts which may hereafter be accepted by the First Commercial Bank at my/our request, I/we hereby deposit with and assign and transfer to said First Commercial Bank as collateral security for the payment of said drafts at maturity, as well as for the payment of any and every indebtedness from the undersigned to the First Commercial Bank.

.....

.....

.....

with such additional collateral as may from time to time be required by the Bank, and which the undersigned hereby promises to furnish on demand. And the undersigned hereby gives to the Bank, or its assigns, full power to sell, assign and deliver the whole or any part of said collaterals, or any substitutes therefor, or any additions thereto, at any Brokers' Exchange or elsewhere at public or private sale, at the option of such holder, on the non-performance of any of the promises herein contained and without notice of amount due or claimed to be due, without demand of payment, without advertisement and without notice of the time or place of sale, each and every of which is hereby expressly waived; and on any such sale the Bank, its assigns of any of its officers, may purchase for its own account and without further accountability except for the purchase price thereof, the whole or any part of the property sold from any right of redemption on the part of the undersigned, which right is hereby waived and released.

It is further agreed that any surplus arising from the sale of said collateral, beyond the amount due hereon, shall be applicable upon any claim of the said Bank arising directly or by assignment against the undersigned at the time of said sale, whether the same be then due or not due.

And it is further agreed that any moneys or properties, at any time, in the possession of the First Commercial Bank belonging to any of the parties liable hereon to said Bank, and any deposits, balance of deposits or other sum at any time credited by or due from said Bank to any of said parties shall at all times be held and treated as collateral security for the payment of any other obligation, liability or indebtedness of the undersigned to the said Bank, whether due or not due.

And I/we also agree to place said Bank in possession of sufficient funds in cash previous to the maturity of said draft, and of any other drafts which the said Bank may hereafter from time to time accept to meet the maturity of said drafts, together with commission as agreed and interest thereon, calculated at the rate of six per cent per annum.

Any and all drafts or bills of exchange now or hereafter delivered by me/us to said Bank to be collected shall be delivered to and received by it as security for said acceptance or acceptances without impairing in any way my/our obligations hereunder to place said Bank in funds before the maturity of said acceptance or acceptances as aforesaid, and all documents relating to

such bills for collection shall likewise be held and received by said Bank as security with the privilege of delivering the same to drawees upon acceptance or payment unless instructions to the contrary shall be attached to each bill.

The said Bank shall have the right to apply the proceeds of such collections against the payment of said acceptance or acceptances and of any other indebtedness due or to become due from me/us.

It is expressly agreed that I/we assume all responsibility for the collection of drafts or bills delivered as aforesaid and for any loss, costs or expenses suffered or incurred by said Bank in connection therewith, and that said Bank shall be held free from responsibility for, and my/our obligation to place said Bank in funds as aforesaid shall not be affected or impaired by, any default, neglect, suspension, insolvency or bankruptcy of any correspondent or sub-agent to whom said bills or drafts may be entrusted for collection, or for any delay in remittance, loss in exchange, or the loss of the said drafts or bills or their proceeds during transmission, or in the course of their collection, and I/we expressly agree to assume all responsibility for, and that my/our obligation to said Bank shall not be affected or impaired by, the non-payment of any bills of exchange which may be received by said Bank, or by any collecting bank, agent or sub-agent in payment of such drafts or bills of exchange.

I/we also assume all responsibility for, and said obligation to place the Bank in funds shall not be affected or impaired by, any risk or error in the course of transmission of telegrams and cablegrams or the loss of letters or other documents which may be sent in connection with the said drafts or bills for collection.

I/we also agree that in the event that any of the said Bank's correspondents, agents or sub-agent for collection of said drafts or bills shall advise it that any of said drafts or bills are not promptly accepted or paid, or in the event of the suspension, failure or assignment for the benefit of creditors, or by the filing of a petition in bankruptcy against the drawee or the drawees of any of said bills or drafts for collection, that I/we will immediately upon receipt of such notice, waiving protest, and notice of protest, pay or cause to be paid to said Bank in cash the face amount of any such draft or bill for collection which has not been accepted or the drawee of which has suspended, failed or assigned or against whom a petition in bankruptcy has been filed as aforesaid.

In the event of my/our suspension, failure or assignment for the benefit of creditors, or of a petition in bankruptcy being filed against me/us, or the non-fulfillment of any obligation hereunder on my/our part shall immediately, without notice, become due and payable, and it is also agreed in either of those events, said Bank may take such action with respect to the collection of any and all of said drafts and bills delivered as aforesaid for collection, as it may deem advisable to protect its interests, and I/we hereby agree to indemnify and the said Bank harmless from any loss, costs, damage, expense (including reasonable attorneys' fees) suffered or incurred by it by reason of such action or by reason of my/our failure to perform any of the obligations arising hereunder.

This obligation shall continue in force notwithstanding any change in the individuals comprising our firm, whether such change shall arise from the accession of one or more new partners or from the death, retirement or secession of any partner or partners.

tained in negotiating the foreign bill. As in the contract for a letter of credit, the exporter binds himself to supply the funds required to redeem the banker's acceptances, regardless of the conduct of his foreign client. This method of financing foreign trade, it is obvious, rests primarily upon the standing of the shipper with his own banker; as a result of the agreement, the bills which appear on the New York market are domestic bills, not differing greatly from similar instruments arising from the internal trade of the nation. The exporter's terms with his foreign customer are not directly involved in this type of credit; but the possibility of availing himself of the banker's acceptance enables the exporter to afford more liberal credit terms to the buyer, and thus indirectly determines the type of foreign bills of exchange which arises from the transaction between them.

58. **The authority to purchase.** There are times, when the terms of sale empower the seller to draw an ordinary trade bill upon the buyer, that the merchants seek to obtain from the banks assurance that the trade bill will be negotiable in the exporter's market. In the ordinary run of international trade, as has been said, the trade bill is not a readily negotiable instrument; often the bankers will handle it for collection only, thus throwing upon the exporter the burden of a period of waiting for his receipts, or compelling him to resort to borrowing a portion of the value of his shipment from the banks at interest. Such terms are not particularly favorable to the exporter; they can be much improved if the buyer will place in the hands of the exporter assurance that the bill will be bought by a banker as soon as it is drawn. The document which embodies this assurance is called an *authority to purchase*.

The procedure by which the authority to purchase is obtained and used is somewhat as follows: An American importer (let us say) gives his banker a guaranty that he will accept and pay the bills to be drawn by an exporter in Manila; the American bank will then authorize its correspondent in Manila to buy the bills out of funds kept on deposit there; finally, the correspondent will inform the exporter of its will-

ingness to buy. This process may be conveniently divided into three phases:

- (a) The relations of the importer to his bank in America.
- (b) The relations between the two correspondent banks.
- (c) The relations between the foreign correspondent and the exporter. We shall examine each of these in turn.

(a) The ease with which an importer obtains from his bank an authority to purchase depends, of course, upon his standing in the estimation of the bank. His request amounts to asking the bank to invest a sum of money upon the strength of his promise to make restitution at a later date; this the bank cannot do without considerable risk, for not only must it rely upon the good faith of the importer to accept and pay the drafts which figure in the transaction, but it must also bear the risk of business failure by the importer during the interval which elapses between the purchase of the bill by the foreign correspondent and its final redemption. The slightest fear that the business of the importer is in an unstable condition, that the man himself is not worthy of absolute trust, or that the particular transaction does not hold forth promise of profit, will be sufficient grounds for a refusal by the bank to engage in the undertaking. If, however, the bank, satisfied on these points, decides to conduct the transaction for the importer, it will require him to sign a document, called a *letter of guarantee*, which lays down the conditions under which the authority to purchase is granted. The following specimen will illustrate the essential features of the letter:

LETTER OF GUARANTEE No. 1000

New York, July 18, 1921.

To the New York Bank

1. In consideration of your bank at Manila negoti-
ating the D/P draft or drafts, at 60 days' sight, drawn and
endorsed by Philippine Export Company on us
for any sum not exceeding \$1,000 we hereby
agree duly to accept the same on presentation, and pay the amount

thereof at maturity, provided such draft or drafts shall be negotiated within 6 months from this date.

With interest at six per cent from date of draft to date of payment by us.

2. At the time of negotiating the above draft, the shippers will hand over to your bank, in hypothecation, as collateral security to you for the acceptance and payment thereof, invoice, certificate of origin, bills of lading and policy of marine insurance for the merchandise, and we agree that in case of need you shall be at liberty to sell the said merchandise and apply the net proceeds toward a payment of said draft without prejudice of your recourse to us thereon and all other parties for any deficit. The word "proceeds" to be understood to include the amount recoverable under any insurance policies covering said merchandise.

3. It is further agreed that you are not to be responsible for any loss or damage that may happen to said merchandise, either during its transit by land or sea, or after its arrival, or by reason of non-insurance thereof, not for any deficiency in the quality or value, nor for any stoppage or detention thereof by the shipper, or by any other person whatsoever. And inasmuch as the above stipulation for handing you the bills of lading is intended for your security, we agree to be liable as aforesaid on the negotiation of such drafts whether the bills of lading be or be not sufficient to cover any advance made by you in negotiating the drafts; and further in case of our acceptance of such drafts conditionally or your handing over the aforesaid documents to us, we undertake to pay the said drafts at maturity, on performance of such conditions, and we authorize you to make such agreements as you think proper with the aforesaid drawers and indorsers, touching the disposition of such bills of lading or the proceeds thereof, or any goods consigned thereby.

(Signed) American Importing Company

In signing this document, the importer accedes to three important conditions:

- (1) In the first paragraph he binds himself to accept and redeem the drafts drawn by the foreign shipper if they conform to certain prescriptions as to amount and usance, and are drawn within a limited period of time. This is a contract which the banker can enforce at law, or upon the strength of which he can recover damages due to default of the importer.

- (2) In the second paragraph, an agreement is made that the goods, represented by the bills of lading, will be delivered to the banker as collateral security. Formal hypothecation of this collateral must be made by the exporter, and the banker is empowered to dispose of the goods, using the proceeds to reimburse himself for any outlay in connection with the transaction, in case of need. Attention is called to the fact that the importer expressly agrees that the depositing of this collateral is not to be considered a waiver of the banker's right of recourse against him and all other parties to the bill. The liability of the importer after acceptance of the bill is not to be reduced by any action which the banker may choose to take concerning the shipment.
- (3) In the third paragraph, the banker is absolved from any obligation to guarantee the goods, or even the shipment of the goods by the exporter. This provision, when taken in conjunction with paragraph 1, has the effect of binding the importer to accept the drafts whether or not the goods are shipped and regardless of the condition in which they reach him.

Thus the effect of the letter of guarantee is to free the banker's claim against the importer from any limiting conditions relative to the particular importation and to base it upon the importer's credit in its entirety, but at the same time to supply the banker with a prior lien upon the goods. In addition to entering into this contract, the importer will be required to pay commission to the banker.

The credit granted by the American bank may be either revocable or irrevocable. The latter is used only in those relatively rare instances in which the bank is dealing with a client who is worthy of the utmost confidence. An irrevocable credit binds the bank to perform its part of the transaction regardless of changes which may intervene to undermine the security of the importer's business, and thus increases the banker's risk of loss. Usually, an authority to purchase is granted on the understanding that it may be recalled by the bank when there is reason to suspect the importer of intended

bad faith, or to fear an unfavorable turn in his business affairs; but revocation can be made only after notice has been given by the bank, and cannot extend to any drafts which have previously been negotiated by its foreign correspondent.

(b) *Relations between the banks created by the authority to purchase.* The foreign bank to which the authority to purchase is to be given will be a branch or a correspondent of the importer's bank in America, the two having entered into an agreement covering transactions of this nature. Notice is sent to the correspondent usually by the simple expedient of mailing a copy of the letter of guarantee to which is appended the request that the correspondent undertake its share of the operation. In the practice of banks, this request is often merely the notation, "Please do the needful," or words of similar brevity written on the back or at the bottom of the letter of guarantee.

To understand the relations of the two banks, it must be made clear that the foreign correspondent is acting merely as an agent for the bank in America, and not as its partner in a profit-making enterprise. As regards the foreign correspondent, the authority to purchase is *permissive*, not compulsory. The foreign bank may properly refuse to engage in the transaction at all, in which case the authority fails of its intended purpose from the point of view of the exporter, for it gives him no power to enforce by legal action the negotiation of his bills. Many exporters, who, in their ignorance of the real nature of an authority to purchase, have confused it with a letter of credit, have learned to their cost that bankers may see fit to disregard requests of this kind and refuse to buy the drafts for which the merchants believed an assured market had been created. However, if the correspondent does buy the drafts, it is done in its capacity of agent for the account and risk of the American bank and the purchase will be made out of funds kept on deposit by the American bank. When these funds prove insufficient to cover the drafts, the authority to purchase will in most instances be disregarded, though it is possible that an advance may be made by the correspondent upon which interest will be charged. If the agree-

ment between the two banks is one of long standing, it may be assumed that the authority to purchase will be faithfully exercised by the correspondent. The risks of this bank are established by the laws of agency which bind it not to exceed its authority, nor to violate any of the conditions laid down as to the character of the drafts and the time limits within which they must be drawn. For its services the correspondent will receive a commission proportioned to the life of the drafts.

(c) *Relations between the foreign bank and the exporter.* Unless instructed to do so, the foreign correspondent will not be bound, by the receipt of an authority to purchase, to inform the exporter of its willingness to purchase his bills. The latter, of course, will have been in communication with his American customer and it can be assumed that he will have been notified of the arrangement made for financing the shipment; but it may be left to him to take the initiative in obtaining specific information from his banker. In case the banker has been instructed to confirm the transaction, the character of his confirmation will depend somewhat upon whether or not the credit has been made irrevocable, and also upon his own willingness to bind himself as agent in an irrevocable manner. The letter received by the exporter in confirmation of the authority will be either in the form of an *authority to draw* or a *notification of advice*, according to the degree of obligation which the banker wishes to assume. The following is a typical authority to draw:

MANILA BRANCH OF THE NEW YORK BANK

Manila, August 3, 1921

Philippine Export Co.
.....

Manila, P.I. .
.....

Dear Sirs:

I beg to inform you that I am instructed by the Manager of our branch at New York to purchase, as offered

your D/P bills drawn at 60 days sight upon
 American Importing Co. to the extent of
 one thousand dollars for the invoice cost of sugar
 shipped to that port.

The bills must be accompanied by full sets of bills of lading made out to order, endorsed in blank and marked by the shipping company, "freight paid," together with invoices and policies of insurance, all duly hypothecated to the bank against the payment of the bills.

Please note that this is not to be considered a Bank Credit and does not relieve you from the liability usually attaching to the drawer of a bill of exchange.

Bills drawn under the above-mentioned instructions must be plainly marked "drawn under your letter of authority no. 1000"

and must be accompanied by this letter that the amount of the same may be endorsed on the back.

Yours truly,

..... manager.

Especial attention is called to the third paragraph of this letter which lays stress upon the exporter's liability as drawer of the bills, for therein is expressed an essential distinction between a guaranty to purchase and a letter of credit. In the case of a true bank credit, the right of recourse by a negotiating banker does not lie against the drawer because of any failure of the *importer* to discharge his obligations to the bank which issues the letter; recourse can be had against the drawer only in one case, namely, failure of the *accepting bank*. But by the terms of the letter of authority, the right to draw is said to be no bank credit, and the legal right of recourse to the drawer is made identical with that of any commercial bill, being conditioned upon the failure of the drawee to discharge his obligations. It is sometimes the practice to issue these authorities to purchase *without recourse to the drawer*. In this case, the purchasing bank will include in the letter of authority some such words as the following: "We are authorized to honor your drafts without recourse to yourselves." This places the drawer in the same position as

the beneficiary of the letter of credit, and increases the risk of the bank which issues the authority. An extra commission is properly charged the importer for his additional risk.

The letter as phrased in the example given is virtually a contract giving the exporter complete assurance of his ability to sell the bills drawn according to its terms. Usually, as has been said, the authority is made revocable at the option of the granting bank, in which case the letter will vary slightly from the form given above, including in the text some such statement as the following:

This letter is for your guidance in preparing the documents and conveys no engagement on the part of the bank. Although it is considered to be open six months from July 18 it may be cancelled by us on giving you notice.

The receipt of a qualified confirmation will inform the exporter that his bills will probably be bought, but does not bestow upon him any legal right. In general practice, however, it may safely be assumed that he will meet with no refusal to purchase if his drafts are drawn in conformity with the instructions.

The buying price for the exporter's bills will be somewhat affected by the terms of the letter of guarantee which defines the importer's obligations to the American bank. In the specimen letter of guarantee which we have given above, it will be noted that the importer engages to pay interest at six per cent during the life of each acceptance from the day it is drawn until he redeems it. These terms obviate the necessity of discounting the exporter's bill when bought by the Manila correspondent, thus providing for the determination of the purchase price on the basis of the sight rate of exchange between Manila and New York. But the full sight rate will not be paid for the bill in any case; the banker's demand draft, to which the sight rate applies, is of higher standing than any credit instrument which one merchant can draw upon another, and is negotiated by the bankers on more favorable terms. The exporter, therefore, will sell his bill at a rate slightly lower than the sight rate, the exact spread between the two

prices measuring the credit standing of the two merchants party to the transaction.

We may now illustrate the foregoing discussion by a typical transaction. Assume that the American Importing Company has bought one thousand dollars' worth of sugar from the Philippine Export Company in Manila, agreeing to supply the sellers with an authority to purchase under which they may draw at sixty days' sight against the importers. The authority is obtained from a New York bank after the importers have acceded to the conditions of a letter of guarantee. If the matter is urgent, a cable will be sent to the Manila correspondent apprising him of his authority to purchase, the importers bearing the extra cost; otherwise, a copy of the letter of guarantee will be mailed for the information of the Manila bank. In due course, the Philippine Export Company will receive a letter granting permission or authority to draw. The ground is now laid for the shipment of the sugar. The goods are insured and placed aboard an outgoing steamer by the exporters, who then draw a draft for one thousand dollars against the American Importing Company, attach to it bills of lading, invoice, and insurance policy, and deliver the resulting documentary commercial bill to the Manila bank. Upon receiving the equivalent of one thousand dollars in pesos at the ruling rate of exchange, the exporters are freed from the transaction, though they bear the contingent liability of a drawer of a bill of exchange. The Manila bank charges the purchase price against the balance of the New York bank and sends the documentary bill forward by mail steamer; it arrives prior to the arrival of the freight steamer which brings the sugar and is presented for acceptance. When the time comes, a trust receipt may be employed to release the bills of lading prior to payment by the importers, or the acceptance may be prepaid by them as a condition of obtaining the sugar, or the goods may be stored by the New York bank until the acceptance matures. These details will be settled by negotiation between the bank and the importer. Payment of the acceptance with interest will clear the importers from all obligation under their letter of guarantee and bring the transaction to a close.

Failure on the part of the Importing Company to pay its acceptance would throw the New York bank upon a number of expedients for the recovery of the money laid out in the purchase of the bill. If the sugar had been stored, or if any portion of it remained in the possession of the bank, it would be sold and the proceeds applied to the importer's debt; action would be brought on the basis of the contract comprised in the letter of guarantee; and, in the final instance, recourse would be had to the drawer of the bill of exchange. The importer, as has been said, bears all risk of misconduct on the part of the Export Company. If the sugar is of inferior quality, or short in weight, the bank will not release the importer from his obligation to redeem the acceptance, nor aid him in recovering damages from the Philippine shippers. Recovery must be effected by action brought on the basis of the sales contract, and the importer must bear the costs involved in legal action.

59. **Relation of bank credits to the exchange market.** Employment of any of these different methods of financing international trade may appear at first sight to break the connection between the movement of wares between the nations and the demand and supply of bills of exchange in the markets. But reflection will show that this is not really true: every shipment of goods, however financed, either increases the supply, in the exporter's market, of bills drawn on a foreign center, or the demand in the importer's market for foreign bills. By the intervention of the banks, the obligation usually borne by buyer or seller to draw or remit foreign bills of exchange is sometimes taken by the bankers; this is the case when a bank credit is established by the importer in favor of the exporter in his own market: the duty of remitting funds between the two markets is assumed by the importer's banker. When an acceptance credit is established by the exporter's banker in his favor, the exporter receives payment for his goods from some money-lender in his own market; but his collection draft, which serves as collateral for the acceptance credit, produces an inflow of funds into the hands of the foreign correspondent to be expended in the purchase of drafts

for remittance to the exporter's banker. In the case of an authority to purchase, the exporter's bill is passed through two funds, both belonging to the importer's banker: the foreign balance in the hands of the correspondent abroad and the cash supply at home; the completed transaction reduces the foreign balance when the bill is bought and increases the cash supply in the home office when the acceptance is redeemed by the importer. In order to engage in transactions of this kind, the importer's bank must repair his foreign balance by buying drafts for remittance to its correspondent.

CHAPTER X

SERVICES OF BILLS OF EXCHANGE IN FOREIGN TRADE

60. Summary of the methods of making payment by means of bills of exchange. We have now concluded our study of the usual ways in which payment may be made by means of bills of exchange in international commercial transactions. It will be our purpose in the present chapter to analyze the services of commercial bills of exchange to the business men who engage in foreign trade, and to discuss some of the problems encountered by those who use them. Before proceeding to this task, however, it may be of use to summarize the different kinds of bills employed in international commerce. In a typical transaction payment may be made in any one of the following ways:

A. By bill of exchange drawn by the seller.

- I. Drawn against the buyer in the buyer's money.**
- II. Drawn against the buyer requiring a return draft in the seller's money or in the money of a third country.**
- III. Drawn against the buyer and supported by an authority to purchase.**

The foregoing bills all result in trade acceptances; with regard to form they may be either:

- (a) Clean bills.** Goods delivered to buyer upon arrival; or,
- (b) Documentary acceptance bills.** Goods delivered upon acceptance; or,
- (c) Documentary payment bills.** Goods delivered either
 - (1) upon payment; or,**
 - (2) upon prepayment with rebate of interest; or,**
 - (3) in advance of payment under trust receipt or other security.**

IV. Drawn against a banker under letter of credit or other bank credit.

(a) The credit is established by the buyer in favor of the seller with a banker located either in the seller's country; or in the buyer's; or in a third country. The bills are drawn in the money of the country in which the bank is located.

(b) The bills are almost always documented; if long bills, the documents are always surrendered against acceptance to the accepting banker, and by this banker to the buyer upon payment; prepayment; or, in advance of payment, under trust receipt or other security.

B. Remittance of a bill of exchange by the buyer to the seller.

I. The remittance is almost invariably a banker's bill, and usually a demand draft or cable; in rare cases a banker's long bill.

II. The bill may be drawn in the buyer's money, or in the seller's, or in the money of a third country.

61. Distribution of risk by means of bill of exchange.

Since the bill of exchange may be said to represent the buyer's attempt to meet the seller's terms in the least expensive and most convenient manner, it will aid us in understanding the services of bills of exchange to the world's business men to examine briefly the terms of sale customary in foreign trade. The expression "terms of sale" embraces two very different elements. In constructing his terms, the seller must, in the first place, set a price upon his goods; in the second place, he must instruct prospective buyers as to acceptable methods of payment. The first of these problems does not greatly concern us. Although the exporter's method of pricing his goods has some bearing upon the character of the bill of exchange used to make payment in the transaction, and upon the costs and receipts of importer and exporter, we may well postpone inquiry into this relationship to a later place. It is with the

other element in the terms of sale that we have to do at present; for in advising foreign buyers of the forms of payment which he will accept, the exporter determines the buyer's range of choice with regard to the bill of exchange which may be employed as an adjunct to the transaction.

In making an agreement with respect to the method of payment, buyer and seller must solve an important problem inherent in all international commercial transactions: the problem of the distribution of the risk. The transaction is exposed to risk of loss from three sources: (a) failure or malpractice on the part of the banks which handle the financing documents; (b) fluctuations of the rates of exchange which adversely affect the costs and receipts of the two parties; (c) business failure or bad faith on the part of either buyer or seller. The first of these risks is so slight that business men habitually leave it out of account; we shall do the same. The second, called the "risk of exchange," is present whenever either party makes commitments whose costs are governed by the position of the exchange rate on a future day, or undergoes costs in consideration of a deferred return whose amount varies with the future fluctuations of the rate. Examination of this risk and of the methods of guarding against it will be made in section 63. The third hazard we may call the "mercantile risk." The seller is exposed to risk of loss through failure or bad faith on the part of the buyer whenever he buys goods, pays wages, or assumes other costs on the strength of an order received from the buyer unsupported by advance payment of cash; or surrenders his goods against the buyer's acceptance of a long bill of exchange in whose negotiation he bears the liability of drawer; or surrenders the goods expecting to receive payment at a later date by remittance from the buyer. The buyer bears a similar risk whenever he pays cash at the time of placing his order and relies upon the good faith and business solvency of the seller to secure a satisfactory filling of the order; or makes a payment or an acceptance in order to obtain the shipping documents, before he has had opportunity to inspect the goods; or binds himself to make a deferred payment regardless of the performance of

the seller (as in the case of a contract for a letter of credit). The terms of sale may call for a method of payment which will throw this risk entirely upon the seller; or entirely upon the buyer; or will divide it between them.

Although the terms of sale in foreign trade vary so widely as to forbid rigid classification, we may divide them roughly into the following groups:

- A. Terms requiring advance payment by the importer.
- B. Terms requiring payment by the importer upon delivery of the goods.
- C. Terms providing for deferred payment by the importer.

A. *Advance payment by the importer.* The buyer makes an advance payment whenever he accedes to the following terms: cash with order; cash against documents at the shipping point; documentary sight draft. To remit cash with his order, the buyer procures a demand draft payable by a bank in the seller's market, or by a bank in a third country, if this is acceptable to the seller. Upon receipt of this remittance, the goods are prepared for shipment, and consigned to the buyer to whom the shipping documents are sent by direct mail. Thus the buyer makes an advance of funds from the time of placing his order until the arrival of the shipment; the seller, on the other hand, having cash in hand before taking the initial step in filling the order, makes no advance at all; nor does he bear any risk. Since the buyer has parted with his money before inspecting the goods, and, indeed, before they have been prepared for shipment, his only recourse in case the order is not filled or the goods prove to be of bad quality, or of short weight, or not what was ordered, is to recover damages by bringing legal action against the seller on the basis of the contract of sale. Terms so burdensome to the buyer are the exception to the rule in foreign trade, but are employed occasionally in transactions of minor importance between firms which have no regular dealings with each other.

Cash against documents at the shipping point are terms requiring the importer to provide payment at the designated point whenever the seller is prepared to surrender shipping documents — invoices, bills of lading, insurance policy — to

show that the goods have been delivered to the transportation company. This is usually done through the establishment of a bank credit in the exporter's market, unless the importer has his own agent in that market and can make the payment through him. If payment is to be made by means of bank credit, the importer will usually be required to pay cash to his own banker at the time of placing the order, and either inform the exporter of the arrangement, naming the bank which is instructed to make the payment in exchange for shipping documents, or request this bank to confirm the credit.

A bank credit of this kind, confirmed and made irrevocable by the bank, relieves the seller from all mercantile risks, since he can obtain the money for his goods by showing the proper shipping documents, regardless of the performance of the importer. In many cases, he obtains payment without the formality of drawing a draft, merely exchanging the shipping documents for the necessary amount of cash at the office of the banker; this sets him clear of the transaction without liability to make restitution. When he does draw a draft, it is usually negotiated *without recourse* to himself in case of non-performance by the drawee. In possession of a confirmed bank credit, the seller has a contract which binds the bank to make payments under certain prescribed conditions; his risk of loss is limited to risk of failure on the part of the *bank*, only. An unconfirmed credit, and one which is revocable at the option of banker or buyer, increases the seller's risk to this extent, that up to the point of shipping the goods he has no enforceable right of negotiation of his drafts, and must bear any costs assumed in preparing the goods for shipment with a chance that the credit will be revoked or the banker will refuse to obey the buyer's instructions to make payment. It is apparent that these methods of payment place the burden of mercantile risk almost solely upon the buyer; yet his risk is not as great as when he remits cash with order. His money is not paid over to the seller until shipment is made, which assures him that his order has been filled; but he has no adequate safeguard against bad faith which results in the shipment of inferior goods, or of goods improperly

packed, unless he maintains an agent in the seller's market who can inspect the shipment.

A documentary sight draft divides the risk between buyer and seller. The exporter must fill the order on the strength of the buyer's promise to make payment, contained in the contract of sale; in assuming costs in connection with the transaction, he not only places confidence in the good faith of the buyer, but also shares with other creditors a stake in the hazards of the buyer's business, since business reverses may intervene to prevent the buyer's making payment despite the best of intentions on his part. These risks the seller cannot evade by selling his sight draft to the bankers, for he will continue liable as drawer until payment is made. The goods must be shipped before the draft can be documented as required by the terms of sale; refusal to honor the draft will, therefore, throw the goods back upon the seller's hands in a foreign market where it will be difficult to dispose of them without loss. The buyer, on his side, makes an advance payment the length of which is determined by the discrepancy between mail and freight time which brings the sight draft to his market in advance of the goods. Since the draft is documented, the buyer need not make payment before he is assured that the order has been filled, but he is not accorded an opportunity to inspect the shipment to determine its sufficiency as to quality and quantity.¹

In the three methods of payment which result in payment in advance of delivery, it will be noted that the recourse of the injured party is to bring legal action against the offender on the basis of the contract of sale. To illustrate, let us consider the procedure in case the documentary sight draft is not honored by the buyer. The seller has not lost possession of his goods, but he is almost certain to lose money in case he cannot force their acceptance upon the buyer and compel the latter to pay the sight draft. Suppose the buyer is guilty of bad faith and the seller wishes to recover damages; what recourse

¹ We assume in making this statement of the buyer's risk that the sight draft is presented for payment upon arrival according to the strict interpretation of its terms.

has he? He holds no financing instrument which bears the buyer's signature acknowledging a debt of a certain definite amount and promising payment at a stated time, such as he would have if the buyer had accepted a bill of exchange. His only claim against the buyer must be based upon the contract of sale. Now, there is an important difference between the task of the seller when attempting to enforce a contract of sale and his task when attempting to collect an accepted bill of exchange. In the latter case, he need only prove the validity of the buyer's signature; he is not required to defend the different items which are included in the total amount stated on the face of the bill. In the former, he must not only prove that the goods were ordered, but also that the order was filled faithfully, and that every item included in his claim is a valid charge against the buyer. It must be remembered, moreover, that his suit will be brought in a foreign court and under foreign laws, circumstances which make it difficult for the plaintiff to inform himself with regard to his exact legal rights and the procedure required to defend them, and which subject him to heavy charges in the form of court fees. A similar burden, of course, is borne by the buyer when attempting to recover damages from the seller by proceedings instituted on the basis of the contract of sale, as he must do if the goods, which arrive after he has paid the draft, prove to be unacceptable.

B. Payment by the importer upon delivery of the goods. In the vast majority of cases, the buyer of goods in foreign trade is offered more liberal terms than those just discussed. To exact payment before receipt of the goods would, under normal conditions, so weaken the seller's competing power in comparison with merchants who were prepared to accord less burdensome terms to the buyer, that he would find great difficulty in developing a foreign market. Somewhat more liberal than payment in advance are terms which require payment by the importer upon receipt of the goods. Such terms place the chief burden of risk upon the seller. He will have assumed costs in preparing the goods for shipment on the strength of the buyer's promise to pay after inspection;

although he retains ownership in the goods until payment is made, insolvency or malpractice of his customer will leave him with the goods on his hands in a distant city and subject to the expense of reshipment, or resale to another buyer in the same market. Whether the importer bears any part of the risk depends upon the method of payment selected by the two parties.

The purpose of postponing payment until delivery has been made to the buyer is usually effected in one of four ways. Sometimes the documentary sight draft is governed by documentary instructions which permit postponement of presentation until the goods have arrived. In certain markets, notably South American, business custom demands that this postponement be made; importers simply refuse to honor sight drafts until the goods have arrived in port, and the bankers handle such bills in full knowledge of this procedure. Surrender of the documents upon payment of the draft gives the buyer possession of the goods upon arrival; from his point of view, the transaction will have been resolved into a cash on delivery sale in which he has adequate defense against bad faith on the part of the seller. The latter bears the risk; his only recourse is to attempt recovery on the basis of the contract of sale. Obviously, this adaptation of the sight draft virtually resolves it into a bill drawn for an indeterminable number of days after date, thus violating the prescription of the law that bills of exchange must be payable at "a fixed or determinable future time."

Another, and more direct, method of accomplishing this result is for the seller to give the bankers a "letter of delegation" which empowers them to collect the amount due from the buyer upon arrival of the goods. A delegation is a document through which one party transfers to another certain legal rights which he possesses — in this case, the right to collect a sum of money from a designated party under certain stated conditions. The correspondent banker in the buyer's market will be bound by the instructions written into the letter of delegation, but within the limits thus set he will be free to act in the rôle of the seller to whom payment is due. The use of

the letter of delegation obviates the drawing of a sight draft by the exporter; the letter, itself, is not a bill of exchange and thus is not subject to the restrictions which the laws of different nations place upon the bill of exchange. This method is sometimes adopted to avoid the payment of stamp taxes which certain countries levy upon bills of foreign origin. From the point of view of the buyer, payment effected in this manner is equivalent to cash against documents in the buyer's market upon arrival of the goods. The risk, again, is borne by the seller whose recourse is to bring action under the contract of sale in the courts of the buyer's country.

A third method of according the buyer opportunity to pay cash upon delivery is the use of a documentary payment bill with the option of prepayment. In most markets, it is now the recognized practice to allow a rebate of interest upon the prepayment of these bills, and they are employed in considerable numbers by importers who wish to conduct their transactions upon a cash on delivery basis. They have the additional advantage of allowing the importer the alternative of postponing payment, and the receipt of the goods, in cases where the market is not favorable to a quick turn-over of the transaction. When other methods are employed to place the transaction upon a cash on delivery basis, delivery of the goods is forced upon the buyer at the time of their arrival in his market; the payment draft, however, places in his hands power to regulate the time of delivery in accordance with the needs of his business while yet avoiding payment in advance.¹ This method makes a somewhat different distribution of the risk than does the documentary sight draft or the letter of delegation. The buyer, though he makes no payment in advance of receipt of the goods, does make an advance *acceptance*, thus subjecting himself to more difficult defense against loss through bad faith on the part of the seller; the latter, for the same reason, is in possession of a better means of defense, since he now has recourse to action on the basis of the acceptance. It is sometimes the practice to relieve the buyer of this risk by postponing presentation of the

¹ See the discussion of the payment draft on pages 186 f.

bill for acceptance until the arrival and inspection of the goods.

A fourth method of payment, similar to the one just described, is afforded by the bill of exchange drawn for a short period *after date*. The tenor of this bill, computed from the time of drawing by the exporter, will be based by the drawer upon the freight time between his market and that of the buyer. With the advent of freight liners running strictly to schedule time, it has become possible to foretell with considerable accuracy how great an interval will elapse between the shipment of the goods and their arrival, and this improvement of marine transportation is causing a greater use of after-date bills, in substitution for payment sight bills, by importers who habitually prepay their acceptances. Any mistake in computing the maturity of the bill, which would result in payment in advance of delivery, is usually corrected by withholding the bill from presentation for payment until the arrival of the goods. Acceptance of this type of bill is made prior to the arrival of the goods; hence, it effects the same distribution of risk between buyer and seller as does the documentary payment draft.

C. Deferred payment by the importer. *Deferred payment*, as the term is here used, means payment deferred after the receipt of goods by the importer. Two methods are usually employed to accomplish this result. The first of these is the documentary acceptance bill which permits the buyer to gain possession of the shipping documents upon acceptance, and of the goods upon their arrival by freight steamer some time later. Unless the acceptance bill is drawn under a letter of credit — that is, in all cases where it results in a trade acceptance — the risks of the transaction fall chiefly upon the seller. He is required to prepare the goods for shipment and look for his defense against refusal of the buyer to accept his bill to his rights under the contract of sale; he surrenders the goods against the buyer's acceptance upon which he must depend to enforce payment in case of default at the maturity of his bill. The buyer is usually called upon to make the acceptance before he has had opportunity to inspect the goods,

though the documentary instructions sometimes provide for postponement of presentation for acceptance until the arrival of the shipment. When such postponement is made, the risks obviously fall upon the seller, solely.

The effect of the letter of credit is to reverse the incidence of the risk, for the seller is then afforded an opportunity to market his bill without recourse in case of default by the buyer, and bears only the risk of failure on the part of the accepting banker. The buyer, on the other hand, is bound by the terms of his contract for the letter of credit to pay a stated amount of money at a future time without regard to the performance of the seller. Since the bills are documented, the buyer is assured that the order has been filled, before his liability under the contract becomes binding; but no guaranty is given him of the sufficiency of the goods as to quantity and quality; his only recourse is to bring action, on the basis of the contract of sale, against the seller in his own market and under his own laws. It must, of course, be borne in mind that the acceptance bill drawn under the letter of credit does not of necessity give the buyer possession of the goods in advance of payment; the acceptance, in this case, is a banker's acceptance, and the shipping documents will be surrendered to the accepting banker. Further negotiation between the buyer and the bank which issued the letter will be necessary before these shipping documents will be delivered to the buyer in advance of payment.

The second method of permitting deferred payment by the importer is the sale of goods on book account, with provision made for periodic settlements of the balance of the account. Goods sold on book account are consigned directly to the buyer who obtains them upon arrival. Settlements are made at predetermined intervals either by sight draft of the seller or by a remittance of sight or cable exchange by the buyer. The risks, here, are obviously placed on the seller, and are so great that this method is not much used in foreign trade.

The foregoing discussion of the character of the bill of exchange as affected by the terms of sale may be summarized as follows:

A. Terms requiring advance payment by the importer.

- (1) Cash with order, effected by a remittance of demand exchange by the buyer at the time of placing his order.
- (2) Cash against documents at the Shipping Point, effected through the buyer's agent in the shipping market, or through a bank credit established in that market in favor of the seller.
- (3) Documentary sight draft by seller on buyer.

B. Payment on delivery of the goods to the importer.

- (1) Documentary sight draft of seller on buyer with presentation postponed until inspection of the goods.
- (2) Collection through a letter of delegation which permits inspection before payment.
- (3) Documentary payment draft with the option of prepayment.

C. Deferred payment by the importer.

- (1) Documentary acceptance bill with or without postponement of presentation for acceptance until inspection of the goods.
- (2) Documentary acceptance bill under a letter of credit with a surrender of the shipping documents against a trust receipt or other security.
- (3) Sale on book account, payment effected by sight draft of seller or by remittance from buyer at stated intervals.

62. The allocation of the transportation and financing costs. Buyer and seller in foreign trade must agree upon a method of disposing of certain costs involved in every transaction in international commerce. For purposes of discussion, these costs may be divided into two groups: (a) the costs of transportation and of insurance against the risks of transportation; (b) the financing costs, including bankers' commissions, stamp taxes, and interest. It may be laid down as a general rule at the outset that all costs in both groups will fall in the final instance upon the buyer, and that, if any of them are borne at first hand by the seller, some method will be devised by which

the seller will reimburse himself. Our interest in the problem is to discover in what ways this incidence of the transportation and financing costs may be effected. Let us consider first the various items included in the cost of insuring and transporting the goods.

Whether the exporter pays any of the transportation costs for the account of the buyer, and, if so, what proportion of them he pays, is determined by his method of quoting goods for sale in foreign markets. It serves the buyer's convenience for the seller to assume these costs and include them in the sale price of his goods; this enables the buyer to ascertain from the quoted price what the goods will cost when delivered, and simplifies his problem of pricing them for resale in his own market. Trade practice in international commerce has resulted in various forms of price quotation which differ with respect to the proportion of these costs assumed by the exporter and included in the sale price; arranged in the order of the proportion of the transportation costs which they allocate to the seller, the standard quotations are the following:

F.O.B. (named point) Free on Board (at that point).
 F.A.S. Vessel (named port) . . . Free Along Side (that vessel).
 C. & F. (named foreign port). Cost and Freight (to that port).
 C.I.F. (named foreign port) . . Cost, Insurance and Freight (to that port).

The "Free On Board" quotation is incomplete without a statement of the point at which the seller's duty to provide transportation cost ends and the buyer's begins. Thus an exporter of cement who offers his goods for sale at a price of \$8 per barrel, F.O.B. Factory, undertakes at this price merely to load the cement on the cars, and places upon the buyer the duty of paying all rail and marine freight, and insurance costs. The same seller, by quoting his price \$8 per barrel F.O.B. Cars, New York, undertakes for this price to pay rail freight to New York where the buyer assumes all costs upon the arrival of the goods in the freight cars. Again, the quotation \$8 per barrel, F.O.B. Vessel, New York, makes a still different allocation of the transportation charges. We may consider

this last form as typical of the F.O.B. quotation in foreign trade, and summarize the duties of the two parties as follows: ¹

A. Seller must

- (1) Meet all costs involved in preparing the goods for shipment.
- (2) Pay all rail freight, dock and lighterage charges involved in placing the goods aboard the out-bound vessel.
- (3) Be responsible for all loss or damage suffered by the goods until they have been placed on board the vessel.

B. Buyer must

- (1) Pay marine freight to destination and port charge at destination.
- (2) Pay insurance costs.
- (3) Be responsible for all loss or damage suffered by the goods after they have been placed on board.

The second standard form of quotation is Free Along Side Vessel at a named port — this port being, in most instances, the port of shipment from the seller's market. The difference between this quotation and the F.O.B. Vessel is not great, consisting principally of a somewhat different distribution of the risk of loss through damage to the goods. When the exporter quotes his price F.A.S. Vessel, the distribution of costs between the two parties is as follows:

A. Seller must

- (1) Meet all costs involved in preparing the goods for shipment.
- (2) Pay all rail freight charges, all storage charges at the port, and all dock and lighterage charges required to place the goods alongside the vessel on the wharf or in lighters.
- (3) Be responsible for all loss or damage suffered by the goods until they have been placed in position for loading on the vessel.

¹ In this summary of the distribution of costs made by the different forms of quotation, the writer follows the rule published by the National Foreign Trade Council.

B. Buyer must

- (1) Pay all marine freight charges, all extraordinary loading costs, and all costs of unloading at the port of destination.
- (2) Pay all insurance costs.
- (3) Be responsible for all loss or damage after the goods have been placed in position for loading.

The third form of quotation, Cost and Freight to named foreign port, is used when the seller includes in his quoted price more of the transportation costs than he is willing to pay when using the F.O.B. or the F.A.S. forms. The C. & F. quotation makes the following distribution of costs:

A. Seller must

- (1) Meet all costs involved in preparing the goods for shipment.
- (2) Pay all land and marine freight charges to the point designated, including all storage, dock and lighterage costs involved in loading the goods at the port of shipment.
- (3) Be responsible for all loss or damage until the goods have been delivered alongside the ship and a "clean" ocean bill of lading — that is, a bill of lading certifying the receipt of the goods in uninjured condition — has been obtained.

B. Buyer must

- (1) Pay all insurance costs.
- (2) Pay all charges involved in taking delivery of the goods at destination.
- (3) Be responsible for all loss or damage from the time the clean ocean bill of lading is delivered to his agent at the port of shipment.

Our exporter of cement, who quotes his goods at \$8 per barrel F.O.B. Vessel, New York, will change this to a C. & F. quotation by ascertaining the marine freight costs to the buyer's port, and adding these costs to his price. He is not, however, compelled actually to pay the marine freight in advance; it is sufficient for him to subtract the freight charges from his quoted price in case he leaves these charges to be paid by the buyer upon the arrival of the goods.

The C.I.F. quotation differs from the C. & F. only with respect to the insurance cost and the responsibility for damage to the goods. The seller uses this quotation whenever he wishes to offer his goods for sale in foreign markets at prices which will relieve the buyers of all incidental costs up to the time when delivery is made by the ship in the port of arrival. The quotation makes the following distribution of costs:

A. Seller must

- (1) Meet all costs involved in preparing the goods for shipment.
- (2) Pay all land and marine freight charges to the foreign port named, together with all costs incidental to loading the goods upon the vessel at the shipping point.
- (3) Pay the costs of insuring the goods.
- (4) Be responsible for loss or damage until the goods have been delivered alongside the outbound vessel and a clean ocean bill of lading and an insurance policy have been obtained.

B. Buyer must

- (1) Pay all charges involved in taking delivery of the goods at the port of destination.
- (2) Be responsible for loss or damage from the time the clean ocean bill of lading and the insurance policy have been delivered to his agent at the shipping point.

In this case, again, the seller is allowed the option of pre-paying the freight or subtracting it from the sale price of his goods. Assuming that the buyer of cement is in Buenos Aires, that the marine freight from New York to that city is \$2 per barrel and the marine insurance $1\frac{1}{2}$ per cent, and, finally, that carload lots are loading in New York from the freight cars free of cost, the exporter of cement will change his price to a quotation C.I.F. Buenos Aires as follows:

Price F.O.B. Cars New York.....	\$8.00 per bbl.
Marine freight to Buenos Aires.....	2.00 per bbl.
Insurance ($\$10 \times 1\frac{1}{2}\%$)05 per bbl.
Price C.I.F. Buenos Aires (carload lots) ..	\$10.05 per bbl.

It will be noted that insurance covers the value of the goods as enhanced by the marine freight charges. By quoting goods in this form, it is obvious that the exporter passes on to the buyer all transportation and insurance costs which he pays for the buyer's account.

We should take account of one other method of quoting goods for sale in foreign markets, a form known as the *franco domicile* quotation. A seller quotes his prices in this form when he is prepared to deliver the goods at the buyer's place of business free of all charge to the buyer. This means that, in addition to meeting the charges placed upon him by the C.I.F. quotation, the seller must pay all costs involved in taking delivery at the buyer's port, pay the customs duties upon the goods, and all costs of carrying them from the port to the buyer's business premises. In view of the variable nature of customs duties and of the seller's difficulty in calculating the costs encountered in the buyer's port, it is not strange that few exporters attempt to quote their goods *franco domicile*. It sometimes happens, however, that the exporter maintains a branch office or an agent in the buyer's city through whom delivery can be made and adopts the *franco domicile* quotation because it serves the buyer's convenience and increases the seller's competing power.

We turn now to the financing costs. It may be taken for granted that these, also, will fall in the final instance upon the buyer, but the means used to pass them on to him are very much affected by the method of payment fixed upon by the two parties when concluding the terms of sale. When these terms call for cash with order or cash against documents at the shipping point, the buyer, obviously, pays all financing costs in advance. Suppose, for example, that the exporter of cement, quoting his price \$8 per barrel F.O.B. Cars New York, concludes a sale of 500 barrels to a buyer in Buenos Aires on the terms cash with order. In confirming his order, the buyer must place in the seller's hands a sight draft drawn on a New York bank for \$4000, paying bankers' commissions required to obtain the draft in his own market and assuming the loss of interest involved in making this advance of funds. Similarly,

if the terms call for cash against documents at New York, the buyer must establish a bank credit of \$4000 for the benefit of the seller in New York payable upon delivery of the railroad bill of lading. (If the seller's price had been quoted F.O.B. Vessel, New York, the documents would have been duplicate steamship bills of lading.) Here, again, the buyer must bear all financing costs in advance of the seller's delivery of the goods. Such terms as these, however, are exceptional in foreign trade. In the vast majority of cases, the seller will surrender his goods in advance of payment by the buyer, and recover the amount owing him, including financing costs, through the medium of a bill of exchange. When payment is effected in this manner, it is the exporter's practice to draw his bill of exchange in such form that it will have a value at the time of drawing equal to the invoice price of his goods; this requires the inclusion in the face of the draft of a "load" or an addition to compensate the financing charges.

The costs grouped together under the term "financing costs" fall into two classes: (a) bankers' commissions, postage and revenue stamps; (b) loss of interest. Conference with his banker will inform the exporter as to the amount of charge of the first class involved in the transaction. Bankers' commissions for handling a commercial bill vary between $1/8$ and $1/4$ per cent for export houses of good standing when the transaction involves markets closely related through the banking structure of the world. They may rise as high as two per cent when unusual costs are involved in their negotiation, or when, for any reason, the banker is reluctant to handle the exporter's paper. Revenue stamps are affixed in the country where collection is made and their amount will be governed by the laws of that country. Postage charges are not always passed on to the exporter, though the banker will waive collection of these charges only in those cases where the exporter's business is so much desired that the banker is willing to bear minor costs himself. In computing the interest loss, it may be necessary to take account of the life of the bill and also of the time consumed in forwarding it to the point of collection; when a return draft is called for, the period required to return

the proceeds of the collection must be added in computing the interest charge.

In explaining the methods by which the financing costs are imposed on the buyer, we can best proceed by considering separately two different conditions: (a) when the exporter's draft is drawn in the buyer's money and the latter discharges his obligation by making payment in this money; (b) when the exporter's draft is payable in his own money or in the money of a third country. We shall assume at the outset, in considering the first type of draft, that the exporter markets his bill at the time of drawing — that is, that he sells it to his banker for its present value in cash. To bring our illustration more nearly into conformity with the realities, let us suppose that the cement exporter quoting a price of \$8 per barrel, F.O.B. Vessel, New York, has sold 500 barrels to an English buyer and has agreed to draw a documentary acceptance bill in sterling at ninety days' sight against a banker in England. Such a bill can be sold at the time of drawing; the banker's buying price, as we have seen in a former chapter, will be calculated from the prevailing sight rate for sterling exchange, the rate of interest which obtains in the London market, and the commission and stamp charges, as follows:

Sight rate of the day of drawing (say).....	4.85
Subtract charges	
Discount ($93/365 \times .05 \times 4.85$)..	.0617
Stamp tax ($1/20\% \times 4.85$).....	.0024
Commission ($1/8\% \times 4.85$).....	.006
	<u>.07</u>
Banker's buying rate.....	4.78

This computation will have been worked out by the banker before an offer is made to the exporter for his sterling bill, and the result, as shown, will be expressed in the form of a rate of exchange somewhat lower than the sterling sight rate. The interest and other financing costs are concealed in the discrepancy between the two rates of exchange.

In possession of the banker's buying price for his sterling bill, the exporter can now turn the invoice value of his goods

into sterling by dividing its amount by the banker's buying rate, thus:

$$\$4000 \div 4.78 = \text{£}836\ 16s.\ 5d.$$

This relieves the exporter of all financing costs; if he sells his bill at the rate of 4.78 (there is, of course, the risk that this rate may have fallen before the exporter can conclude his transaction) he obviously recovers the \$4000 which is the present value of his goods. The importer pays interest and other financing costs when he redeems the sterling long bill at maturity.

By this simple method, exporters pass the financing costs on to the buyers when they draw in the buyer's money and market their bills. It is also *possible* to use the same method when these bills are not sold, but placed with the bankers for collection, but it is highly improbable that the seller will consent to recover financing costs in this way when receiving payment through collection bills. In the case just considered, the interest charge paid by the buyer is not received by the seller of the goods, but by that money-lender in the discount market who buys the bill of exchange after acceptance. When collection bills are employed, however, this interest payment goes to the seller by reason of the fact that this party waits for his returns until the maturity of the bill, at which time he receives the buyer's payment in full with the subtraction of bankers' commissions and stamp charges. To apply the same method to the drawing of collection bills, therefore, will require the seller to make an advance of funds at the rate of interest obtaining in a foreign acceptance market, whereas the real cost of making this advance will be determined by the rate of interest applicable to commercial loans in his own market. For this reason, a somewhat different method of computing the interest charge is adopted in connection with bills placed with the bankers for collection. The seller makes out his invoice as before, and adds as a separate and distinguishable charge against the buyer, interest at the commercial rate in the seller's market, plus bankers' commissions and stamp charges. The bankers' commissions will be a per-

centage of the *face of the draft*, not of the net sale price; it is the practice to compute the interest charge, also, not on the net sale price, but on the face of the draft. The following example will illustrate the method.¹

500 bbls. of cement @ \$8.00	\$4000.00
Interest ($90/365 \times .06 \times \4073.31).....	61.10
Commission ($1/4$ per cent $\times \$4073.31$).....	10.18
Stamp tax ($1/20$ per cent $\times \$4073.31$).....	2.03
Invoice total.....	<u>\$4073.31</u>

The invoice total may be turned into sterling at the sight rate obtaining in New York at the time of drawing, or at a nominal rate, previously agreed upon between buyer and seller, approximating the sight rate. The long sterling rate, it must be understood, cannot be used, since it contains an allowance for interest; if used, therefore, to convert the invoice total which also includes an interest charge, the buyer would be charged twice for the interest. Assuming that the exporter will draw at the rate of 4.85, his bill will call for the payment of £839 17s. 2d. ($4073.31 \div 4.85$). In this case, the risk of exchange to the seller is greater than when he markets his draft; the proceeds will be turned over to him at the time of the collection and at the rate of exchange obtaining at that time; this rate may be either higher or lower than 4.85, the rate employed in converting his invoice into sterling.

We come now to the method employed to shift the financing costs to the buyer when the exporter's bill calls for a return draft in his own money or in the money of a third country. In this case, the waiting period for which interest will be de-

¹ In the example before us, interest is computed at 6 per cent per annum for three months, which is equivalent to $1/2$ per cent per month or $1\frac{1}{2}$ per cent of the invoice total. The commission is assumed to be $1/4$ per cent, and the stamp tax $1/20$ per cent. The sum of these charges (interest $1\frac{1}{2}$ per cent, commission $1/4$ per cent, stamps $1/20$ per cent) is $1\frac{4}{5}$ per cent which must be figured on the invoice total. Four thousand dollars, the net price, is, therefore, $98\frac{1}{5}$ per cent of the total. Given this information, to find the total of the invoice is a simple problem in arithmetic:

\$4000 is $98\frac{1}{5}$ per cent of the total;
 1 per cent of the total is \$40.7331;
 100 per cent of the total is \$4073.31.

manded by the exporter covers the life of his bill plus the mail time to the buyer's market and return, since payment is not consummated until the return draft is in the seller's hands. In the foreign trade practice of the United States, these return drafts are of four varieties: (a) drawn in dollars at sight; (b) in dollars at ninety days after sight; (c) in sterling at sight; (d) in sterling at ninety days after sight. In each case, the seller's task will be to draw the bill in such form that the return draft will have a value *on arrival* equal to the total of his invoice, including interest and other financing costs; this will give the bill a value at the time of drawing equal to the sale price of the goods.

Under normal conditions, return drafts are not used in our trade with Europe, but are frequently employed in South American trade.¹ Accordingly, we must vary our illustration in order to bring it into conformity with trade practices. Suppose, then, that the exporter of cement has sold 500 barrels at \$8 per barrel, F.O.B. Vessel, New York, to a buyer in Brazil and is to draw at thirty days' sight for a return draft in dollar sight exchange; the mail time both ways may be assumed to be sixty days; the rate of interest in New York, 6 per cent; the bankers' commission which the exporter pays, 1/2 per cent. The exporter's bill of charges against the buyer would appear as follows:

500 bbls. of cement @ \$8.00	\$4000.
Interest ($90/365 \times .06 \times 4081.63$)	61.22
Commission ($1/2$ per cent $\times 4081.63$)	20.41
	<hr/> \$4081.63

He will draw a bill reading as follows:

Thirty days after sight pay to the order of the First Commercial Bank \$4081.63. Payable in sight drafts at the bank's drawing rate on New York on the date of payment.

The return draft will be worth its face upon arrival and will, therefore, reimburse the exporter for all financing costs in

¹ This subject has already been treated (see pages 194-202). It is included in this place for the sake of giving our discussion of the trade practices the merit of completeness.

addition to paying him the value of his goods. If a return draft in dollars drawn at ninety days' sight is called for, its amount should be such that it will sell for \$4081.63 upon arrival. The cost to the Brazilian buyer of a dollar sight draft for \$4081.63, will be the same as the cost of a ninety-day dollar bill which will sell for \$4081.63, upon arrival in New York;¹ the long bill, however, gives the buyer a valuable opportunity to postpone payment and obtain an additional period of payment. The exact amount by which the dollar long bill must exceed the sight draft will, of course, be determined by the discount rate in the New York market for bankers' acceptance of ninety days' usance.

When the return draft is to be sterling exchange, its amount should be determined by the same principle of giving it a value of \$4081.63 upon arrival. In this case, however, the seller can, at best, hope only to receive approximately the required amount of dollars when selling the return draft, since its value will be determined by the rate of exchange at the time of arrival — ninety days after drawing, in our illustration. This obviously throws his transaction open to risk of exchange. If the return draft is to be sterling sight, he may employ the sterling sight rate obtaining at the time of drawing in order to convert the invoice total into pounds; but it is obvious that the rate of exchange may either rise or fall before the return draft is placed in his hands, and that his receipts may be affected, correspondingly. In like manner, when a return draft of long sterling is called for, he may convert the invoice total into pounds at the long rate obtaining at the time of drawing; but, again, the transaction will be open to risk of exchange. We shall consider the means the exporter may employ to guard against this risk of exchange in the section immediately following.

In this summary of the methods of disposing of the financing costs, we should take account of one other method frequently employed in connection with exporter's bill calling for return drafts. Perhaps the majority of such bills bear the

¹ This is true because the dollar long rate in Brazil is lower than the dollar sight rate by an amount governed by the rate of discount in New York.

interest clause; the exporter draws for the sale price of his goods plus bankers' commission — \$4020 in the illustration we are using — and writes upon the face of the draft:

Payable at the bank's drawing rate on (the appropriate city conforming to the nature of the return draft) on the day of payment, with interest at per cent from the date of drawing to the approximate date of arrival of funds in New York.

This is the only type of bill which places the interest charge explicitly upon the buyer. The interest clause is not used except where return drafts are called for.

63. How the risk of exchange is handled. At various points in the preceding discussion, reference has been made to the risk of exchange; we shall now proceed to examine the methods by which this risk may be avoided or minimized. Risk of exchange is borne by buyer and seller in international commerce whenever either party assumes costs in consideration of a return whose amount will be affected by a future rate of exchange, or contracts to buy goods whose cost will be affected by a future rate. The risk is inherent in the fact that, when effecting payment in foreign trade, either buyer or seller or both must convert costs or receipts into a foreign money. Unless the terms of payment call for cash with order or cash against documents at the shipping point, this conversion into a foreign money must be made at a future date when the condition of the exchange market cannot be known with certainty. The risk may fall solely on the seller, as when he prices his goods in a foreign money and draws a bill payable in this money at a future date. Or it may fall solely upon the buyer, as when he buys goods priced in a foreign money and agrees to buy foreign exchange for this amount at a later date. Or, it may fall upon both parties, as when the exporter draws under a sterling letter of credit, having quoted his price in advance of drawing; and the buyer, having accepted the goods thus priced, is bound by his contract with the bank issuing the letter to cover the exporter's bills in sterling at a later date.

Certain rough-and-ready methods are available to business men whose foreign transactions are of no considerable im-

portance whereby the risk of exchange may be avoided. Exporters, for example, may price their goods in their own money and refuse to convert these prices. This will very seriously restrict their choice of terms of payment, since they cannot agree to draw in the money of the buyer nor accept letters of credit issued against foreign banks; practically the only means of payment available to them when pursuing this policy is a remittance of dollar exchange by the buyer either in advance of delivery or subsequent thereto. Importers, on the other hand, may insist on price quotations in their own money and accede to no other terms of payment than bills drawn in that money; this policy, also, is incompatible with wide extension of foreign transactions. Again, both exporters and importers may adopt conversion tables which translate dollar prices into foreign moneys, and *vice versa*, at fixed rates sufficiently below or above the actual rates to allow for any probable fluctuation of the market. Generally speaking, however, foreign merchants cannot conduct transactions of any considerable proportions without incurring risk of exchange. When this is the case, they may guard against the risk by carrying on "hedge" transactions in the exchange market.

The hedge is a deal in a future contract for the purchase or sale of foreign bills; its purpose is to inform the merchant of the rate at which he can buy exchange needed at a future date, or can sell exchange which he will be empowered at a future date to draw. On the side of the exporter, a typical hedge transaction would be somewhat as follows: An exporter of bacon, let us say, has received in May an inquiry from an English buyer for a quotation in sterling upon a shipment to be made in August and financed by a ninety-day sterling draft. Before quoting his price, the exporter may inquire of his banker what rate he will offer for a sterling long draft to be delivered in August, thus informing himself in advance of the conditions under which he can convert his bill for the bacon into dollars and cents. He can then adjust his price so as to insure a profit and, if the sale is made, immediately place in the banker's hands a contract to deliver a given amount of sterling at the rate of exchange agreed upon. A hedge trans-

action for an importer would consist in the signing of a contract with a banker to buy a stated amount of foreign exchange at a stated price upon a given date. For example, an American buyer of English cutlery may place an order for a shipment of goods priced in sterling and agree to make payment by remittance of sterling demand drafts upon arrival of the goods. While he has the order under consideration and is calculating its profitableness, it will give accuracy to his calculations if he can foretell at what rate of exchange the sterling demand drafts will be sold him on the day of payment. Accordingly, he inquires of his bankers at what rate they will contract to supply the needed amount of sterling on the given day, and, having placed his order, signs the future contract which assures him possession of the exchange at the predetermined rate.

It must not be understood that the bankers who deal in these future contracts are always speculating with the course of the exchange rates. In most cases, they will cover one type of future contract with the other and take their profit from the slight difference between the rates at which they agree to buy and sell. In others, they will be contracting to buy and sell future exchange because they have already sold or bought other bills payable in the same money on future days, and wish to foretell the rates at which they will be able to realize upon their transactions. For example, the banker who contracted to sell the future exchange to the importer of cutlery may have bought commercial long-payment bills which will mature at about the same date as that on which the sterling demand drafts will be delivered to the importer; his contract with the importer is merely the method by which the banker discovers in advance the terms upon which he can employ the sterling credit which accrues from the collection of the payment bills. Similarly, the banker who contracts to buy the exporter's sterling draft may have drawn finance bills to mature on the same date and wishes to secure cover for these bills at a predetermined rate. Bankers make use of these futures in sufficient numbers to create in a smoothly functioning exchange market opportunities for business men

engaged in foreign trade to hedge against the risk of exchange in all their transactions. Business houses of long standing are, as a rule, ready to reduce the speculative element in their trade to a minimum by availing themselves of these opportunities to hedge.

64. Economic functions of commercial bills. Our study of commercial bills of exchange has made it clear that such a bill, as a servant of the world's business men, may perform one or both of two distinct economic functions: (a) it may facilitate the collection of money owing in a foreign country, discharging what we may call the "function of collection"; (b) it may enable the business men to call to their aid financial resources other than their own when carrying through a transaction; this we may call a "financing function." Not all bills of exchange are of such a nature as to perform both of these services together; some act as a collection agency only; others, as a collection and as a financing agency; none as a financing agency alone. The distinction in form between commercial bills which determines their fitness to perform these functions is somewhat difficult to confine in a simple formula, but the following sentence is an attempt to express it so: *When commercial bills of exchange are payable on presentation (sight and demand drafts of all kinds), they perform the collection function only; when they embrace a time element (long bills of all kinds), they perform both the collection and the financing function, unless they are handled by the bankers for collection alone.*

It is the purpose of the following sections to analyze these economic services of bills of exchange in so far as they relate to commercial transactions between nations.

65. The collection function of bills of exchange. When a sight draft is used to effect payment in a commercial transaction, whether it is drawn by the exporter and redeemed by the importer, or bought by the importer and cashed by the exporter, the bill of exchange has no power to increase the financial resources of the two parties. The draft merely transfers funds from one to the other, causing an outgo and an income which, disregarding fluctuations in the rates of exchange, are equal to each other, and adding nothing to the combined re-

sources of both buyer and seller. To state the same truth in a different form, the purchasing power of an importer over goods in a foreign country — the base upon which he conducts his business — is limited to his own cash resources when a sight draft is used as a mode of payment, just as really as if he had expended money directly in the purchase of the goods. This statement does not imply that neither exporter nor importer may call upon the banks for aid; both parties may rely upon loans for a large part of the funds with which their transactions are financed. But this aid is not received through the instrumentality of the sight draft, since the draft accomplishes nothing more than collection from the buyer of the amount owed the seller.

Within its sphere thus limited, however, the sight draft plays no insignificant rôle in facilitating the international commerce of the world. It promotes a continuous flow of commodities from one country to another by removing obstacles which would otherwise stand in the way of the development of international trade relations, obstacles created by the distance which separates the two markets, the difficulties of dealing in two distinct systems of coinage, and the diversity of legal and customary procedure which make mutual understanding and confidence difficult to attain. Its aid enables the merchant to make and receive payments in the foreign, with the same ease as in the domestic, department of his business; through its agency, the financial side of international commerce is resolved for both buyer and seller into a simple negotiation with a near-by banker and in a familiar medium of exchange, throwing upon the banks the task of bridging the distance between the two markets and of translating one coinage system into the other. In discharging its function as an agency of collection, the bill of exchange increases the convenience and the confidence with which sales of goods can be made in distant markets, and serves to unite the nations of the world into closer economic union.

Furthermore, in performing the collection function, bills of exchange reduce the cost of carrying on trade between nations and thus make in the direction of a cheaper and more

plentiful supply of goods in all the markets of the world. Commerce implies a double transfer of wealth, the transfer of goods from seller to buyer and of other goods, or money, from buyer to seller. Each transfer has its own peculiar costs, important among which, in international commerce, is the cost of physical transportation; and these costs restrict exchanges and operate to increase the scarcity of goods. But for the foreign bill of exchange, both of these transfers of physical wealth would be a necessary part of almost every international transaction; the total cost of making the trade would then be the sum of all the costs involved in both transfers, and goods would have to sell at a price high enough to recover this total cost. As we have seen, the transportation of gold from one nation to another is an expensive operation, necessitating an expenditure of labor in handling the gold at both ends, a burden on the shipping facilities of the world, and a period of many days' waiting during which the gold is available for the purpose of neither buyer nor seller. If each importation required the exportation of an equivalent amount of money — and this would be largely true in the absence of bills of exchange — shipments of gold in amounts large and small in and out of the country would be a daily recurring necessity, involving in the aggregate an enormous cost in labor and waiting, a cost which would burden and restrict the exchange of commodities between the nations. The employment of bills of exchange as collection agencies places the duty of shipping gold upon the bankers who act as middlemen for buyer and seller, and this permits the impounding into large aggregates of the countless number of small sums which importers of each market owe their foreign creditors; hence, credits may be offset against debits and only the balance which remains payable from the aggregate trade of an extended period need be transported across the seas. By reducing to a small fraction the gold shipments which would otherwise be necessary, labor and capital are released for the performance of other wealth-producing services, and the business world is relieved of the major proportion of the loss of time involved in the transportation of gold between distant markets. All labor-saving

devices have as a necessary consequence an increased plenty of goods and services available for the satisfaction of human wants, and this important service the bill of exchange renders as a phase of its function as an agency of collection.

Bills of exchange resolve the exports of a nation into a fund of international purchasing power available for the uses of any individual within the exporting country who desires to buy of the goods and services of foreign peoples. The nation's foreign sales bestow upon its people the power to create drafts payable in other countries; this power is passed to the banks, merged in a common fund, and apportioned in suitable amounts to importers who need buying power which has currency abroad. Thus, the insuperable obstacles of barter are obviated without destroying that foundation upon which all trade must rest. Considered as a whole, the nation still barter exports for imports; but within the nation, the exporters and importers, employing bills of exchange as agencies of collection, receive payment for their sales and make payment for their purchases in domestic money. Exporters are free to seek out the most profitable foreign markets without regard to the ability of these markets to supply the imports desired by the exporter's country; importers, in turn, are free to buy what and where they please, regardless of the suitability of their country's exports to meet the needs of the markets in which they buy.

These many services of the bill of exchange, functioning as an agency of collection, are most in evidence in abnormal times when the exchange markets of the world have broken down and the world's traders are denied the aid upon which they have come to rely. The trade of the United States with Australia is customarily financed by bills which bear the Colonial Clause; that is, bills payable in London by remittances of sterling exchange. Australian merchants sell wool and grain to England, pass their sterling bills to Australian banks, and thus supply their banks with London credits against which to draw bills for the use of other Australian merchants. Americans sell farm machinery and other products to the people of Australia, draw against the buyers bills

payable in sterling, and the buyers cover these bills by utilizing the sterling credits created by Australian exporters of wool and grain. In normal times, this triangular use of bills of exchange admirably serves the needs of the business men in both markets. But the breakdown of the exchange market which developed toward the end of the year 1920 brought this practice to an abrupt halt; the collapse of the wool market made it impossible for Australia to establish a sufficient credit in London, and Australian importers found themselves unable to purchase sterling drafts. Firms in America which had sold farm machinery to Australia discovered that there was no way of collecting the money owing them; the importer in Australia, though solvent and willing and anxious to make payment, could find no bank in his market which would take his money in exchange for sterling bills; and the American exporter's banker was forced to refuse to buy bills which could not be covered in London. The bill of exchange had temporarily ceased to function as an agency of collection. Other markets, notably South American, were similarly affected at the same time; American exporters found that the alternative to the bill of exchange — direct barter of exports for imports — was so expensive and cumbersome as to prove destructive of international trade.

66. The financing function of bills of exchange. All commercial bills of exchange, whatever their form, act as agencies of collection, discharging the services discussed in the preceding paragraphs. Those bills which provide for the receipt of money by the exporter in advance of payment by the importer — that is, all commercial long bills except those taken by the bankers for collection only — render in addition the important service of supplying from outside sources funds to facilitate the transaction between exporter and importer.

International trade is a time-consuming process; if buyer and seller provide from their own financial resources the means for carrying through each commercial transaction, one of these individuals must make an advance of funds in consideration of a deferred return. The burden of this advance may fall upon buyer or seller according to agreement; upon

buyer, if cash is paid for goods upon delivery and the buyer looks to a subsequent sale to recover the amount advanced; upon seller, if goods are sold on credit, the seller parting with their value and expecting a return at some future date. Only a limited trade could be carried on if the burden of the advance must be borne by one of the two merchants, since, forced to rely upon their own limited resources to tide them over a period of waiting, they would in many cases be compelled to halt further operations until a preceding transaction had been liquidated. The traders, it is true, might borrow from the banks upon the basis of their general credit, but, in the absence of bills of exchange, it would be difficult to devise a method of borrowing which would base the loan upon the security of the goods changing hands, and thus make the foreign commercial transaction self-liquidating.

To finance a transaction means to advance the means of covering its costs in expectation of repayment at some future date. In the economic structure of modern society, a distinct group of business men has developed whose primary function it is to supply the money or credit needed to finance mercantile transactions, to bear the burden of waiting for a deferred return in consideration of a reward in the form of interest upon the funds advanced. The commercial long bill enables traders in international commerce to avail themselves of the financing function of the bankers; it relieves the importer of the necessity of paying for his purchases cash on delivery, allows him a period of time in which to consummate the transaction for which the importation was made, so that the resale of the goods may provide the funds required to discharge his obligation to the foreign exporter. Through the aid of commercial long bills, importations may be made to a large extent self-financing; the importer's receipts often antedate the cost of redeeming the bills of exchange. Nor need this service to the importer necessarily imply a corresponding burden upon the exporter, provided the bills of exchange which he draws can be sold to the bankers as soon as the shipment is made. When this is the case, the bill of exchange will remain in the hands of some banker or money-lender during the inter-

val which separates the exporter's receipts and the importer's payment, and will provide a remuneration for the financing service through its growth in value as it approaches maturity. The commercial long bill, if bought by the exporter's banker, plays a double rôle in international commerce; it not only effects the collection of the debt owed by importer to exporter, but, also, increases the financial resources of the two merchants by providing access to the supply of loan funds in the money market. It must be noted, however, that this double service is possible only when the nature of the bill is such as to induce a banker to buy it outright at the time it is drawn. The financing function of bills of exchange is conditioned upon their marketability.

At this point we may again call attention to the superiorities of the commercial letter of credit as a financing agency in international commerce. All drafts drawn under the authority of a letter of credit are marketable, while most trade bills are not; hence the letter of credit places in the exporter's hands an instrument capable of performing a double economic service. This results from the fact that the credit of a bank has been substituted for that of a merchant in the capacity of acceptor of the bill, and, consequently, the buyer of the bill bears a diminished risk of loss. An elaborate system of guarantees, devised to safeguard the interest of the banks, makes this substitution possible. The accepting banker is protected under the terms of the acceptance account by the unconditional liability of the bank which issues the letter to provide funds for the redemption of all acceptances; the issuing banker is, in turn, protected by his contract with the importer whose terms hypothecate the goods as collateral security, and, in addition, gives the banker recourse to the importer's general assets in case of default. Substituting a banker's credit for a merchant's enables the traders to appropriate from the discount market the funds needed to consummate the transaction. From the point of view of the importer, the goods are bought on credit; they arrive in his market in advance of the maturity of the drafts drawn by the exporter, and the importer gains possession of them through the means of a trust

receipt, or otherwise, before he is required to pay their cost. But the exporter sells them for cash — cash advanced by an unknown money-lender of the discount market whose aid is tendered upon the strength of the credit of the accepting bank acting in behalf of the importer.

The ultimate effect of the financing service of bills of exchange is expanded trade between nations and a more plentiful and a cheaper supply of goods in the markets of the world. Trade expansion would be confined within very narrow limits if the buyer in each instance were compelled to finance the transaction out of the liquid resources of his business, just as, within the domestic market, the gigantic undertakings of modern industry would be impossible if each enterpriser were restricted to the use of his own purchasing power. During the year 1920, goods of all kinds to the enormous value of eight billion dollars were sold by American business men to customers of every nationality; no such trade could have taken place upon terms of cash payment; its very magnitude is evidence of the development of credit relations in international commerce. But the sale of goods on credit in distant markets would be hampered by almost insuperable risks to the seller if his interests were protected by no greater security than the good faith or the solvency of an unknown customer, as would be the case were the exporter to part with his goods in exchange for a promise to pay or upon the basis of an open account. The private credit of a merchant does not extend far beyond the frontiers of his own country; it does not suffice to command the goods of manufacturers and merchants in distant markets. But this private credit is frequently great enough to procure from a local banker a letter of credit, which, placed in the hands of a foreign seller, is effective in extending the importer's purchasing power to the products of foreign lands, thus increasing the supply of wares in his own market.

Any commercial long bill, provided it can be sold by the drawer, has the effect of bestowing an international credit upon the importer. But the drawer of a trade bill must carry a risk of the failure of his foreign customer, even after he has

sold the bill for cash to his own banker. Since the legal right of recourse to him as drawer can be exercised by the buying banker if the importer refuses, or is unable, either to accept or to redeem the draft, his profit is subjected to the trade hazards of the importer's business. On the other hand, when empowered to draw under the authority of a letter of credit, the exporter can part with his goods without concern as to the credit of his customer, since it is only a default by the accepting bank which makes operative against him the right of recourse. As a financing agent, the commercial long bill, and especially the long bill drawn against a banker, reduces the credit risks in foreign commerce, multiplies the exchanges which take place between national markets, and, consequently, increases the quantity and reduces the price of commodities in the world's trading centers.

This beneficial result of the financing function of bills of exchange may be established by a different method of approach. It is an axiom of economics that goods in all markets must in the long run command prices high enough to cover their costs of production. Among these costs is one to which the name "financing cost" may properly be given, represented by the interest payments required to induce lenders of money and credit to advance the funds needed to carry the operation through its many phases. To protect his profit, an exporter who sells goods on credit must add his loss of interest to the sale price. If the long bill which he draws is taken by the bankers for collection (that is, if it does not function as a financing agency), the exporter loses interest during the life of the bill at a rate equal to that charged for a loan by his banker of a similar amount. If the bill is sold, the exporter still loses interest during its life, but at the rate used in discounting its face in order to determine its present value; this rate is established in the discount market in which the acceptance is sold. In either case, the goods must be priced sufficiently high to return this loss of interest to the exporter; otherwise we should be forced to the violent assumption that business men choose to forego a part of their profit when engaging in foreign trade.

Now, the rate of discount applied to a marketable trade

bill is ordinarily lower than the rate demanded of a merchant when contracting a loan at his bank, for the reason, already mentioned, that a bill of exchange enjoys a higher standing as a credit instrument than a promissory note; hence, when the financing function is discharged by a bill of exchange, the interest cost of the transaction is lower than when the bill serves only as an agency of collection, and the sale price of the goods will, under competition, be correspondingly lower. Similarly, the rate of discount applied to a banker's acceptance is lower than that commanded by the commercial trade bill, because of the superior credit rating of the acceptor; and, again, the necessary consequence under competition must be a correspondingly lower sale price for the goods. In brief, when a bill of exchange is the financing agency, the cost of placing the goods on sale in the foreign market is smaller than when other means of financing the transaction are employed, and smallest when the bill used is a banker's acceptance. Underlying this statement is the fact that commercial bills of exchange, and especially bankers' acceptances, throw open for the use of business men engaged in foreign trade the resources of the world's greatest banking centers, where funds can be borrowed for short terms at the lowest possible rates of interest.

CHAPTER XI

FOREIGN INVESTMENTS AND THE EXCHANGE MARKET

67. Investments in long bills of exchange. The lending of capital by individuals in one country to those in another, the payment of interest upon past loans, and the redemption of maturing obligations comprise a group of forces of growing magnitude in the exchange markets of the world. No credit transaction involving individuals or governments of different nations can be carried through without affecting the demand for, or the supply of, foreign bills of exchange in the markets concerned, influencing the rates of exchange, and reacting upon the currents of international commerce. Reference has been made to these forces at various points in the preceding chapters; for the purpose of studying them in greater detail, we shall now divide them into two major groups: (a) investments of funds in foreign long bills of exchange; (b) investments in foreign stocks, bonds, and other securities. The first of these groups is the subject of the present section.

Exchange bankers, by virtue of their position as middlemen handling a vast assortment of long bills, have abundant opportunity to select for their own uses those instruments which possess the highest investment standing;¹ and it has long been their practice to invest current funds in foreign long bills whenever market conditions were favorable. In the great majority of transactions, however, the purchase of a long bill by an exchange banker does not represent an investment, or advance, of his own funds; it is the general rule of

¹ A foreign long bill, to be considered an attractive investment by a banker, must have the following attributes: (a) it must be drawn upon a banker; (b) the open market in the drawee's city must be broad enough to assure the buying banker a ready sale of the bill in case he wishes to close out the investment; (c) the bill must be payable in gold. These attributes in the past have been possessed, in a preëminent degree, by the sterling long bill drawn on a London banker. Such a bill has security, liquidity, and convertibility into gold — all of which are essential to good bank assets.

the banker's business to offset purchases of long bills by sales of sight drafts at the same time and to substantially the same amounts. The long bill is forwarded to the foreign correspondent with instructions to discount immediately after acceptance has been secured, and the sight drafts, which go forward by the same steamer, exhaust the proceeds of the discount as rapidly as they accrue. By this process of equal purchase and sale, the banker is able to conduct a large volume of dealings in foreign bills without investing any considerable amount of money on his own account in the instruments in which he deals. His profit is drawn from the slight difference in his favor between the rates at which he buys and sells, and does not contain any element of interest earned upon capital advanced by him, except when he offsets his purchases by sales of cables.

This standard transaction of the exchange banker has been explained before, but in order to contrast it with the banker's investment in a foreign bill, it may be well to give it emphasis by another illustration. Let us assume, then, that a New York banker is asked to negotiate a sterling long bill for ten thousand pounds, drawn on a banker in London. In order to negotiate this bill without investing in it, the banker must recover the money he spends, immediately. He first calculates the amount of sterling credit the bill will create when discounted immediately after acceptance in London. Utilizing the appropriate discount rate of the London market — let us assume it to be 5 per cent — and the bill's length of life (sixty days) he finds the acceptance will sell for £9948 4s. and 4d. ($10,000 \times 3/100 \div 63/365$). A stamp charge of $1/20$ per cent will be levied in London; this will reduce the amount by £5, leaving a net sterling credit of £9943 4s. and 4d. If the sight rate for sterling on this day is 4.85, the banker can sell this London credit for \$48,224.61 (9943.21×4.85). By paying somewhat less than this amount for the sterling long bill¹

¹ It is not to be understood that bankers carry out this calculation on the occasion of each transaction; the sterling long rate is computed from the sterling sight rate with the intention of accomplishing this result of obviating an advance of funds by the buying banker, and this rate is used for all transactions of like character. See page 80.

and immediately proceeding to sell sterling sight drafts which will exhaust his London credit, the banker will avoid making an advance of funds and yet draw a profit from the transaction.

To turn the above transaction into an investment in foreign exchange, the banker need only omit discounting the long bill after its acceptance in London;¹ this will prevent him from selling the sterling sight draft and so will result in his making an advance of the funds expended when the long bill is bought. His decision to make this investment will turn upon two points (we are assuming that the bill, itself, is an attractive investment instrument): (a) the position of the discount rate in New York as compared with the discount rate in London; (b) the banker's forecast as to the future trend of the sterling sight rate in his market. The influence of the two discount rates on the banker's decision will become clear when we realize that the banker will have an alternative use for the funds which he advances when buying the long bill, and that he will choose the more profitable of these alternatives. By keeping his money in hand, he can make it earn interest at the rate prevailing in New York; by buying the long bill, he will gain the difference between the price he pays for it and its worth at maturity, and this difference will be determined by the interest rate of the London market. In other words, by investing in this bill, the banker will sacrifice interest at the New York rate and gain interest at the London rate; hence, the first condition precedent to his decision to invest is that the London rate of interest be higher than the New York rate.

¹ It is the act of discounting after acceptance, or refraining therefrom, which determines whether the burden of waiting for a deferred return will be thrown upon the money-lenders of the drawee's or the drawer's market. *Some one* must make this advance of funds when a long bill is employed by exporter and importer. If the exporter sells his bill outright to the banker (and this is the only case we are considering), his sale is resolved into an exchange of goods for cash; but the importer will make no payment until many days later. When the bill is sold in the discount market after acceptance, it is a money-lender of the drawee's market who bears the burden of the advance; when the discount does not occur, this burden is borne by some one in the exporter's market.

The second condition has to do with the probable behavior of the sterling sight rate in the banker's market. The banker, if he invests in the sterling long bill, cannot wind up the transaction, nor can he ascertain his profit, until he has transferred the proceeds of his investment, accruing in London, to his own cash drawer in New York. This he must do, sooner or later, by selling a sterling draft on the New York market; and, since all sterling rates are controlled by the sight rate, the number of dollars realized by the banker — whether the draft he sells is a sight or a time draft — will depend on the position of the sterling sight rate at the time he withdraws his funds from London. Obviously, if the sterling sight rate falls after he makes his investment, a part of his gains will disappear in the process of transferring his funds from London to New York. On the other hand, if the sight rate advances, his gain will be increased when the transfer takes place. The banker may guard against the speculative element in this transaction by selling sight exchange for future delivery; but the rate of exchange fixed in this future contract will be remunerative to the banker only if it is the feeling of the New York market that the sterling sight rate will advance, or, at least, will not fall, in the meantime. Hence, it may be said that, when New York bankers buy sterling long bills for investment, they give evidence of their prediction, or the prediction of their market, that the trend of the sterling sight rate is upward.

It must not be inferred from the statements just made that the investor in a foreign long bill is compelled to retain his investment until the bill matures. Though he refrains from discounting the bill immediately after acceptance, the banker does not lose the power to discount at any time prior to maturity if conditions change so that it becomes desirable for him to release his investment. When negotiating a foreign long bill, the banker sends the bill forward for acceptance in the shortest space of time irrespective of his decision regarding investment in it. The securing of acceptances is equally important whether the banker invests or discounts the bill. The contingent liability of the drawer does not become binding unless an effort is made to secure acceptance within a

reasonable space of time after drawing. Moreover, in the case of all bills payable after sight, the term of life is calculated from the date of the acceptance, and the banker by delaying presentment will, therefore, receive no interest during the time lost in securing acceptance. These considerations induce the bankers to forward bills bought for investment as quickly as they do those which they discount. But the procedure of forwarding varies slightly in the two cases. The practice of the market, when it is the banker's intention to discount, is to endorse and forward by separate mails both the first and second of exchange, either of which may be presented for acceptance, thus voiding the other. However, when the banker decides to invest in the bill, the first of exchange is sent forward for acceptance *without endorsement*, while the second is retained by the banker. The accepted bill cannot be discounted, since it lacks the banker's endorsement, but the second may be endorsed and sent forward whenever it is desired to terminate the investment; the two copies, one bearing the drawee's acceptance and the other the payee's endorsement, make a discountable instrument. The foreign bill of exchange, if drawn on a city in which exists a ready discount market, is, therefore, a highly convertible instrument.

Under normal conditions, it is not often that money-lenders other than bankers invest in bills of exchange drawn upon, and payable in, foreign markets. But one result of the abnormal exchange conditions which have followed the close of the Great War, has been the attraction into the market of investors and speculators from the outside, persons with money to lend, who have responded to the lure of the extremely low sight rates and bought foreign bills in the hope of a rising market. The bankers have encouraged and facilitated this contribution to the investment funds of the market by advancing a part, sometimes one half, of the purchasing price, using the endorsed copy of the bill as security in the transaction — a process similar to margin speculation on the stock exchange. Another method of facilitating these investments used by the bankers is the drawing of long "date" bills

as substitutes for long acceptance bills; the banker takes the long acceptance bill and covers it by selling his own long date bill for a similar amount to another investor. The date bills are convenient instruments for those who have no correspondents in the foreign market through whom to obtain acceptance. They are drawn for periods which are usually ten days longer than those customary in long sight exchange; that is, a date bill of seventy days will correspond to a sight bill of sixty, and a date bill of one hundred days to a sight bill of ninety. The investor can hold such a bill until it is within ten days of maturity and then sell it as sight exchange, since it will then be payable on arrival in the foreign market (allowing ten days for the passage through the mails). This makes it possible for the investor to withdraw his funds within the sixty and ninety day periods customary in dealing in long sight bills. Bankers who issue these date bills usually allow the investor the option of returning them ten days before maturity to be swapped for sight exchange on the same market.

At one time during the recent unsettlement of the exchange market there was considerable speculation in bankers' sight exchange, which partook of the nature of investment for short periods. The speculator bought bankers' checks payable in a given foreign city, not with the intention of forwarding them for payment, but with a view toward holding them for a rise in the exchange rates and of selling them in the New York market at a later date. During the period when these sight drafts were held off the market, the transaction had the same effect as any investment in foreign bills. Many of the bankers, objecting to this practice because the delay in forwarding the drafts increased the risk of failure by the foreign correspondent and of recourse to themselves, have put a stop to the practice by stamping upon their demand drafts a clause requiring that they be presented within a certain space of time at the office of the foreign correspondent. This type of investment is, therefore, not so frequent as it once was; speculators have turned to the purchase of the paper moneys of the countries in whose exchange they wish to speculate as a transaction very similar to that of buying bankers' sight upon

these countries. Short term investment in bankers' sight drafts is still carried on, however, to a certain extent.

One other form of investment in foreign bills has arisen in recent years as the result of the credit strain following the Great War. The prostration of Europe, and the inability of importers of even the highest credit rating to make current payments for goods bought in the United States without great losses in exchange charges, have induced many American sellers to coöperate with their foreign customers to ease the situation. Liberal credit terms are extended—terms of nine months or a year—and bills of exchange bearing the return draft requirement are drawn for these periods, accepted by the foreign importers, or their agents in this country, and held by the exporters until maturity. This arrangement has the purpose of giving the importer time to complete the transaction for which the goods were bought before making payment, and, at the same time, of relieving the exporter from the necessity of selling his bill in a low market. The return draft requirement, it may be well to state, obligates the acceptor to redeem his bill at maturity in dollar sight drafts; thus the drawer is not required to negotiate the bill at any time. Obviously, such transactions as these merely represent a different method of selling goods on open account; the investment made by the exporter is equal to the value of the goods he agrees to ship now in consideration of a deferred return, and his interest charge is added to the sale price of the goods. In reality, a large part of the capital of exporters locked up in investments of this kind has been advanced by the banks through an indirect process. With their working capital absorbed in these long-term foreign credits, exporters have been compelled to resort to the banks for loans with which to carry on their domestic transactions, availing themselves of the customary "line of credit" established by bankers in favor of their clients. Though borrowing ostensibly for a different purpose, the exporters' demand for bank credit has been increased by the inability of the exchange market to liquidate foreign transactions.

Investment in foreign long bills in any of these forms exerts

its effect upon the exchange market by temporarily reducing the amount of sight drafts offered for sale. The obvious result of this is to raise the sight rate (and, consequently, the rates for long bills), or, at least, to prevent the rates from falling as far as they might otherwise do. To establish the truth of this statement, it need only be recalled that the essence of an investment in foreign bills, from the standpoint of the banker, is the decision to postpone the use of these bills as cover for sight drafts until a later date. A substantial volume of such investments will lend support to the exchange market at a time when the rates are falling under the pressure of a large volume of bankers' sight drafts, as, for example, during the years immediately following the Great War, when exports so vastly outweighed imports in the foreign trade of the United States. But unless the investments are renewed at maturity by the substitution of new long bills, their effect upon the exchange market will be brief; maturing bills will be brought back to the market, thus giving rise to the volume of sight drafts which was removed when the investment was made. Moreover, since the long bills have a higher value at maturity than they have when drawn, and create a larger foreign credit when held for investment on this side, the investment process will *increase* as well as postpone the volume of sight drafts.

68. **Foreign long-term investments.** The initial effect upon the exchange market of investing in foreign stocks, bonds, and similar long-term securities, is not different from that of investments in foreign bills of exchange. The buyers of foreign securities place their funds in the hands of domestic bankers who undertake to forward them to the borrowers in the foreign countries. The forwarding of the funds may be effected in either of two ways. The domestic bankers may buy drafts payable in the borrowers' country for remittance to the borrowers or their bankers; or, the borrowers may be instructed to draw for the amount in question upon this market. Obviously, both of these methods of payment will increase the demand for foreign bills in the lending market. In the first case, this is done directly; for the banker who has received

the investor's money turns it into drafts for remittance to the sellers of the securities. In the second case, the process is indirect, but not substantially different in its effects. The bills drawn by the sellers of the securities will be bought by some one in the foreign market and forwarded for redemption by the banker who has received the investor's money; this will leave the banker's market in the debt of the borrowing market and increase by so much the need of making remittances of foreign bills. Consequently, the purchase of foreign securities by American investors tends to raise the sight rate on foreign bills and the other rates of exchange which depend upon it.

Again, the influence of these long-term investments at the time of maturity does not differ from that exerted by investments in long bills of exchange. Unless new securities are substituted for those which have matured, the investors will withdraw their funds by placing their securities in the hands of some domestic banker to be redeemed and cancelled. The redemption of these securities will give the bankers foreign credits against which to draw sight drafts, thus adding so much to the supply of these drafts on the market and tending to depress the rate of exchange. Between these two points in their history — their purchase by American investors and their redemption by the foreign borrowers — foreign securities give their owners the right to receive periodic payments of interest. These payments increase the supply of exchange drawn on the borrowing market. The investors clip their coupons, and pass them to the bankers for negotiation; the coupons constitute just so much sight exchange payable in the debtors' market.

As the amount of foreign securities held by investors within the country increases from year to year, and the size of the annual interest payments mounts, two counteracting forces are brought to bear upon the exchange market. The new investments create a demand for foreign bills; the interest payments, a supply of these bills. Usually, during the early years of its experience as a lending nation, the annual additions to the foreign securities held by a country's citizens

outweighs the sums owing on account of interest payments and maturing investments, with the result that these international loans create a net annual addition to the demand for foreign bills in the nation's market. This period, however, can scarcely continue indefinitely; for the increasing interest payments plus maturities will, in time, overbalance new investments and reverse the effect upon the exchange market, by creating a net addition to the supply of foreign bills.

69. The effect of investments on international commerce. The chief significance of the forces we have been considering lies beyond their effect upon the exchange market and inheres in the influence which they exert through the medium of that market upon the currents of international commerce; to these ulterior effects we now turn. Between individuals, the creditor-debtor relationship is usually created by some such process as the following: A surrenders something of value to B, receiving no immediate payment except in the form of B's promise to make payment some time in the future; A is then B's creditor until the deferred payment takes place. When we view the different nations as trading units whose relations with each other are analogous to those of individuals, it is apparent that one nation can become the creditor of another only through a substantially similar process. Nation A delivers valuable goods or services to nation B, receiving no current payment other than some evidence of indebtedness; henceforth, nation A is the creditor of nation B until the deferred payment takes place. When paying interest or redeeming maturing obligations, nation B must reverse this process and surrender valuable goods or services without receiving payment other than a release from debt. To state the matter in other words, the lending nation attains its creditor position by reason of a favorable balance of trade — that is, an excess of goods and services exported over goods and services imported; when the point is reached at which annual interest receipts plus maturing obligations exceed the aggregate of annual new investments, the balance of trade becomes "unfavorable." Obviously, no nation can lend its lands, mines, or other immovable wealth; it can surrender to foreign people

only those things which enter into international commerce — that is, the products of its capital and labor. Equally obvious is it that, if the nation is to *lend* these things and not merely to *sell* them, she must fail to receive payment in the form of other products exchanged for them. Likewise, the creditor nation must accept from the debtor, in payment of interest and maturing obligations, the valuable products of the debtor nation's capital and labor, since the payment can take no other form.

When thus simplified by disregarding the multitudinous transactions of individuals and viewing only the relationships of the nations as a whole, the effect of foreign investments upon international commerce becomes quite clear: the purchase of foreign securities, or of foreign bills of exchange, by individuals within the country enables a nation to export more than she imports. But the actual process of the exchange market, by means of which myriads of unrelated transactions work out this national result, remains to be explained. Let us consider first the investment in a foreign bill of exchange. We have seen that, in order to buy a commercial long bill without making an advance of funds, the banker must recover his money immediately by selling a demand draft of equal value. The fact that he is able to sell this demand draft is proof that some individual in his market is under obligation to make a remittance abroad, an obligation which is the result of the receipt from abroad of a valuable consideration — either goods or services imported, or a release from a previous debt, or a property right in the wealth of a foreign people, or something else. The banker's purchase price for the commercial long bill represents an exporter's receipt for something of value exported; the banker's sale price for the demand draft represents an importer's payment for something of value imported; any discrepancy between these two amounts is the banker's remuneration for his services as a middleman. If the two commercial transactions in which the long bill and the demand draft are employed be brought together in a single account, it will appear that the nation has both given up and received things of

equivalent value, although each business man carries on his transaction with a view solely to his own profit and with no thought as to the effect upon the nation's trade as a whole. This is not to say that the exports must have gone to the country from which came the imports; for we know that sterling long bills (for example) are used to finance exports to other countries than England, and sterling demand drafts to pay for imports from other countries than England.

Contrast with this result the effect of the banker's investment in the commercial long bill. His purchase price, as before, makes payment to some exporter for something of value which has left the shores of the nation; but his decision not to use the long bill as cover for a demand draft prevents this particular export item from being offset immediately against an import item. If this type of investment runs on for a considerable period of time, and if the sum total of foreign long bills held by investors steadily increases, the nation will continue to export goods without receiving payment for them. For the sake of emphasis, we may repeat that these exports need not go to the nation, or nations, in whose bills of exchange the investments are made; the whole trade of the nation must be taken into account when tracing out the effects of these investments, but when this view is taken, the fact is clear that foreign investments enable the nation to finance an excess of exports. Except for these investments, an excess of exports would create a supply of sight drafts so large in proportion to the demand for them, that the exchange rates would decline to the point where exports were burdened and imports stimulated, thus tending to restore equilibrium in the foreign commerce of the nation.

Although an excess of exports can be financed through the purchase of foreign long bills for investment, this type of investment is so short-lived that it can afford only temporary relief to the exchange market. The typical commercial long bill runs for ninety days from sight; when such a bill is bought for investment, the drawing of sight drafts against the value of the goods sold abroad will be postponed for a short time only; and when the drawing occurs, the amount of sight

drafts will have been increased by the act of investment. Unless the investment operation is repeated by the substitution of new bills for maturing ones, and unless the amount held by investors constantly increases, the excess of exports will soon make itself felt on the exchange market. The sight rate will fall under the pressure of the drafts drawn to close out the investments, and the declining rate will either cause an inflow of gold which will raise prices and diminish foreign sales; or, if the inflow of gold is prevented, a burdensome exchange charge will develop which so increases the foreign buyer's expense of making payment as to diminish exports. Relief for the exchange market, when the nation has a continued excess of exports, must be sought from foreign investments of longer term than the foreign long bill of exchange. Long-term investments, once made, do not soon return to disturb the exchange market; years or decades may elapse before the funds are withdrawn, and, during this period, a growing volume of such investments will lend support to the exchange market and permit a long-continued favorable balance of trade.

But the exporters of goods are not often content to dispose of their wares in exchange for long-term promises to pay. Business men engaged in production and merchandising must liquidate their sales within short periods in order to meet recurring costs; they could not continue long in business if they were to obligate themselves to meet their costs in cash while conducting their sales on long credits. Hence, the persons directly responsible for the excess of exports are not the ones who acquire the foreign securities against which these exports are offset. The exporters dispose of their bills of exchange in the usual ways, either selling them for cash to the bankers or depositing them for collection; in either case, they receive money payment for their goods, though the nation of which they are a part receives neither money nor anything else more tangible than a promise to pay. However, there are other individuals within the country who, with money to invest, are willing to buy foreign stocks and bonds solely on their merits as investment instruments. These money-lenders

are in no wise concerned with the sales problems of the exporters; yet, by transferring their funds to domestic bankers for the purchase of foreign securities, they create a demand for bills of exchange which takes off the market those drawn by the exporters and thus permits the latter to receive cash for the goods they sell abroad. If no one in the country were content to invest in foreign securities, the exporters would be forced to rely for the sale of their bills upon funds placed in the bankers' hands by the purchasers of demand drafts — that is, by the importers — and the problem of financing an excess of exports would soon grow acute.

By a similar process, the overturn of the nation's trade balance, which occurs when interest receipts annually outweigh new loans, is financed through the medium of the exchange market. Individual importers make payment in the usual ways, either by remitting demand drafts or redeeming the bills of their foreign creditors. But with the supply of foreign bills brought to the market by investors to whom interest payments are due from abroad added to the supply offered by the exporters, the demand of importers will clear the market only on condition that imports are in excess of exports; and, if the market is not cleared, the rates of exchange will fall to the point where exports are burdened and imports stimulated. The investors present their interest coupons to the bankers, who, by negotiating them, acquire the right to draw foreign bills. The market for these bankers' bills is among the importers; if they buy them all, in addition to those drawn against the bills of exporters, we have proof that imports are in excess of exports. The declining rate of exchange will produce this excess of imports in case it is not present at the outset.

The relationship between foreign investments and the currents of international commerce may be illustrated from the trade history of the United States. As a young country, possessed of undeveloped resources, the United States was a *borrowing nation*, importing goods and services in excess of exports and offsetting the unfavorable balance of trade by selling in foreign markets the stocks and bonds of her indus-

tries and governments. The sale of these securities created foreign credits in favor of American banks against which bills were drawn in payment of the excess of imports. Succeeding this stage, and as a consequence of it, the United States was placed in the position of a *debtor nation* whose obligations to make remittances of interest and principal exceeded her annual borrowings from abroad, leaving a net payment to be discharged by means of an excess of exports. The American bankers who made these payments on behalf of the debtors within the country employed foreign bills of exchange for this purpose, thus affording an outlet for the bills of exporters. These two periods covered the history of the United States from its origin as an independent nation down to the outbreak of the Great War.

The effect of the war was suddenly to make of the United States a *lending nation*. American securities owned abroad were returned to this market in large volume, thus reducing the indebtedness of our country to foreign peoples; and, at the same time, immense loans were made by our Government to foreign nations. Both of these currents of securities were offset against the unprecedented excess of merchandise exports which characterized the trade statement of the United States from the outbreak of the war down to the present time (1921). The sale on our market of foreign owned securities, and of the bonds of foreign governments, combined to place American banks under obligation to make remittances abroad, thus creating a demand for the foreign bills of the exporters who, otherwise, would have found no purchasers. At the present time, the United States continues to have a large favorable balance of trade; but that the increase in our foreign investments no longer suffices to finance the excess of exports is evidenced by the collapse of the rates of exchange and the difficulty of negotiating foreign commercial bills. Short-term investments in foreign long bills have afforded some measure of relief to the overburdened exchange market. However, unless there is an increased and continued purchase by American investors of foreign long-term securities, the favorable balance of trade must decline and disappear as the handicap

upon our export trade imposed by the premium on the dollar in foreign markets grows progressively heavier. Eventually, in any event, the growing interest payments due our investors must cause an overturn of the trade balance; additional foreign investments will postpone this event, but not avert it entirely.

Certain aspects of the relationship of foreign investments to international commerce require further explanation. The position of the United States at the present time, at the conclusion of a period of lending marked by a continued excess of exports, and upon the verge of the succeeding period when, as a creditor nation, she must receive large annual interest payments in the form of imports, has alarmed many people who have imperfectly grasped the relation of the exchange market to foreign commerce. It is feared that, since the industries of the country have been adjusted to a large volume of exports, the influx of imports will unsettle our industrial structure and undermine the economic prosperity of the nation. This fear is to a large extent founded upon a misapprehension: namely, that the imports sent to us in payment of interest must of necessity be the products of the countries which are our debtors. It happens that the securities we own are those of manufacturing nations whose products would enter into competition with our own and thus conflict with our traditional protectionist policy. But these imports need not come from the nations which are under obligation to pay us interest. As explained above, our right to receive interest payments will create a supply of exchange drawn upon the debtor countries, but this exchange may be used to effect payment for imports from any quarter of the world, provided this mode of payment is acceptable to the exporters. By a triangular process, our sterling and franc exchange may be transferred to exporters in South America, the Far East, or Australasia in payment for the products of these countries, to be used by the exporters to discharge payments due to France and England. The exchange market acts as a clearing house for foreign credits and debits arising from the total commerce of the nation; it is the balance of commerce with the world in

general which is affected by the forces we have been explaining. When, as a result of investments, the nation is empowered to receive a net payment from abroad, this payment will take the form of an excess of imports in her total commerce; and attempts to prevent this result by means of prohibitive tariffs or otherwise, unless these attempts actually destroy the right of the creditors to receive their interest, must prove ineffectual. The pressure of foreign bills upon the exchange market will bear down the rates to the point where imports become profitable despite a penalizing governmental policy.

70. Investment trusts. Realization of the fact that American investment in foreign securities is now essential to a continuance of our favorable balance of trade has stimulated interest in the agencies which undertake to create a demand for these securities among the investing public. It does not fall within the compass of our subject to describe these agencies at length; one of them, however, relies for the consummation of its purpose upon direct intervention in the exchange market, and to this some attention may profitably be given. This is the investment trust, organized under the Edge Act. Its function, expressed in summary form, embraces the following operations: First, it takes over the long-term securities of foreign borrowers who desire to establish a credit in the United States for the purchase of American goods; against these securities as collateral, the trust issues its own debentures to American investors; finally, it uses the funds acquired in this manner to take up the bills of exporters whose products the foreign borrowers wish to obtain. From the standpoint of the nation, these processes achieve the same result as does any foreign investment: goods are exchanged for long-term promises to pay. But the problem of placing these long-term promises with American investors is obviated by the expedient of substituting for them the bonds of an American financial corporation whose credit obligations find a much readier market with the investing public. The scheme is especially devised to relieve the exchange market from the pressure of exporters' bills at a time when the trade balance is favorable,

by calling forth the investment funds of the money-lenders for the purchase of these bills by a roundabout process.

In foreign countries, financial institutions of this kind have long been in operation, and under the banking laws of certain states, similar institutions have been carrying on substantially similar operations in the United States. An amendment to the Federal Reserve Law, passed in 1916, empowered national banks with a capital of \$1,000,000 or more to invest not more than ten per cent of their capital and surplus in such corporations; the McClean Act, which became a law in September, 1919, removed the limit set by the prescription of a minimum capital and permitted all national banks to coöperate in forming investment trusts by subscribing not more than five per cent of their capital and surplus; finally, the Edge Act, passed at the close of 1919, provided for federal incorporation of investment trusts, prescribed regulations to govern their activities, and placed them under the supervision of the Federal Reserve Board. Financial institutions incorporated under federal law with a minimum capital of \$2,000,000 may now accept long-term securities as collateral for their own debentures, issuing the latter to an amount not to exceed ten times their capital and surplus. With the funds raised by the sale of their debentures, these corporations may buy exchange in the open market, or negotiate the bills of particular exporters. The functioning of these institutions on a large scale will relieve the pressure of commercial bills upon the exchange market, and so furnish a means of financing a favorable balance of trade.

CHAPTER XII

THE EXCHANGE MARKET — LONDON

THE most casual student of foreign exchange has frequently come upon such statements as these: "London is the center of the world's trade"; "the vast preponderance of international trade is financed with sterling bills"; "the exchange business of the world is cleared through London." The truth of such statements, so far as they relate to the conditions which preceded the Great War, cannot seriously be questioned. Business men engaged in foreign trade have discovered from experience that the commercial long bill, drawn in sterling against a bank in London, has offered the most convenient and the cheapest method of discharging the collection and financing functions required to complete international mercantile transactions. Exporters of many countries have drawn in sterling for the sale price of goods shipped to markets outside of England; importers in these markets have been required to cover these drafts at maturity by remittance of sterling demand bills to London; hence, a flood of commercial bills arising from all quarters of the world has streamed into the London market, to be offset by a corresponding stream of remittances, the two currents of sterling bills being cancelled against each other, or "cleared" in this great banking center. Whether or no the economic changes wrought by the Great War will leave the supremacy of London undiminished, that market will always hold a position of such importance in international trade that some knowledge of its mechanism is essential to an understanding of the business of foreign exchange. In the discussion which follows, we shall limit our inquiry to those features of the London market which are essentially related to the subject of foreign exchange, avoiding as far as possible the technicalities of the banking business in its domestic aspects.

71. Correspondent relations between London and foreign banks. The drawing of commercial and bankers' sterling bills in the markets of the world implies that banks in those markets have established certain connections with London. These connections, in many cases, are created by the establishment in London of branch banks of the parent institution in the foreign market, but the necessary relation is much more frequently the product of correspondent agreements drawn up between independent banks in the two centers. A large share of the foreign business handled by the great incorporated or private banks of London arises from these correspondent agreements, agreements which have the effect of making the London bank either a partner or an agent of the foreign bank in transactions which involve the two markets. Each institution remains distinct in ownership and control, each free to seek a profit from the business of its domestic market in any manner pleasing to itself; they are united only for the purpose of mutual profit from the handling of certain international transactions upon terms laid down by the contract which they form with each other.

Closer bonds of union between London and foreign centers are formed when branches of the same banking institution, operating under a common ownership and control, are founded in the two markets. Viewed from the standpoint of London, these branch banks fall into two divisions: London offices of colonial banks — that is, branches of the great central banks of Australia, Canada, New Zealand, and other parts of the British Empire outside the United Kingdom; and London offices of foreign banks, comprising, before the Great War, approximately fifty branches of banking institutions of America, Asia, and Europe not embraced within the British Empire. The relations formed between home offices and their London branches cannot strictly be called correspondent relations, since the two institutions are in each case organically united and their operations are controlled from a common center and for a common profit. Yet, in practice, the branch bank has been managed under a separate system of accounts which has caused its transactions with the parent institution to assume

the appearance of relations between separate firms, and these transactions have been carried on upon terms and by methods closely resembling those of independent banks.

To understand the relationships created by a correspondent agreement, it is necessary to inquire for what purposes a bank outside of England seeks to establish connections with London, for the agreement will be so framed as to fulfill these purposes. Our previous discussion has shown us that the foreign bank seeks power to do certain things: (a) to buy sterling commercial bills, or to take such bills for collection, turning them over to the London agent for negotiation in England; (b) to draw sterling demand drafts for sale to its clients; (c) to secure the service of the London bank as acceptor for sterling bills, drawn either by the foreign bank or by some other individual under the authority of a letter of credit issued by the foreign bank. Now, there is an essential distinction between the power required to perform the first two of these groups of transactions, and that required to perform the third. When a New York banker buys sterling commercial bills or takes such bills for collection, and when he sells his own sterling demand drafts, he operates on the basis of a cash balance maintained in London; the commercial bills will cause an inflow of funds to be credited to this balance by his London correspondent, and the demand drafts will be redeemed out of these funds. Consequently, to carry on the transaction included in groups (a) and (b), the New York banker must establish and maintain a *foreign balance*, and must engage the services of a London banker as agent for the management of this balance, crediting it with certain items, charging it with others, and informing the New York banker of its condition at intervals.

But the third group of transactions cannot be carried on upon the basis of a foreign balance alone. Sterling long bills drawn for acceptance by the London banker, whether they be finance bills drawn by the New York banker himself or commercial bills drawn under a letter of credit, will be carried by the London correspondent as a liability of the New York banker, not charged to the foreign balance until they mature

many days after acceptance. During the interval between acceptance and maturity, these bills must be accounted for in such a way as to disclose clearly the nature of the relationship between the two correspondents which has been caused by them, and this requires the opening of an *acceptance account*. The agreement which a New York banker forms with his London correspondent, in order to answer completely all of his purposes, must, therefore, cover the details of both the foreign balance and the acceptance account. Ultimately, of course, the acceptance account will be brought to bear upon the foreign balance; for all acceptances made by the London agent on behalf of the New York banker will be redeemed from the latter's foreign balance, and in preparation for these charges the New York banker must make a remittance of cash items before the acceptances mature. Thus the entire volume of bills handled under the acceptance agreement will ultimately pass through the foreign balance.

72. The foreign balance. The amount of money which can usefully be kept on deposit in London varies rather widely for different American banks. Like all other phases of its business, any bank engages in exchange operations for the purpose of gaining a profit, and is governed in the details of its transactions by the rules of business efficiency. The size and character of its clientèle must determine how profitable are the services made possible by the investment of a part of its capital in a foreign balance, and, therefore, how large this investment should be. Naturally, the concern of the bank will be to operate on the minimum balance commensurate with its needs; and, having determined what this minimum is, to maintain the balance at this figure as nearly as possible from day to day. This can be done only by so marshaling the credit and debit items which pass through the hands of the London correspondent that they will approximately offset each other over brief periods of time. If the supply of commercial bills sent over for credit to the balance is unduly large at any time, a correction will be made by selling demand drafts or cables to exhaust these excess funds; if, on the other hand, the charges against the balance by reason of the maturity of acceptances

in large amounts tend to draw it down too far, the American bank will buy demand drafts or cables in the open market and send them over. In connection with these various operations, the London correspondent will be called upon daily to perform a number of services for the American bank, chief among which are the following:

- (a) To receive all commercial bills sent over, obtaining acceptances upon them, discounting them in the money market, or collecting them at maturity, and crediting the balance with the proceeds.
- (b) To care for the documents which usually accompany the bills; arranging for the surrender of bill of lading under terms of a trust receipt, or otherwise; attending to the warehousing of the goods if this is necessary; and enforcing the performance of the importer's obligations as laid down by the terms of sale.
- (c) To receive from the American bank by mail or cable demand drafts on other London banks; to send these through the clearing house, or collect them by runner; and to credit the foreign balance with the proceeds.
- (d) To cash across its counter traveler's checks; checks drawn under a traveler's letter of credit; and sterling demand drafts and cables sold on this side, charging the balance with these expenditures.
- (e) To redeem all mature acceptances of sterling long bills drawn against it by the American bank or under letter of credit issued by that bank, debiting the balance with the amount.
- (f) To perform a number of incidental services, such as investing any surplus funds in securities at the order of the American bank; selling such securities when so instructed and crediting the balance with the proceeds; receiving and sending shipments of gold; making remittances on behalf of the American bank to neighboring cities, buying all necessary revenue stamps for the documents handled and charging their cost to the balance.

The agreement drawn up between the two bankers must

provide for the discharge of all these services and for the compensation to be given for them. We shall return to the subject of compensation a little later.

Besides arranging for the performance by the London bank of the different services outlined above, the correspondent agreement will usually contain some stipulation concerning the amount of the balance to be maintained and the interest to be paid on this deposit. It is the frequent practice to set a minimum below which it is understood the American banker will not allow his balance to fall, but the figure is viewed more as an average than an absolutely rigid lower limit to the balance. In certain cases, however, and especially if the two institutions have had a long and profitable association with each other, no minimum at all is set, the London bank relying upon the good business sense of its American correspondent to maintain a sufficient deposit to meet all normal requirements. Under such conditions, also, it is not unusual to allow overdrafts, the American bank being charged with interest upon that portion of the draft covered by the funds of the London correspondent. But these are not typical cases; usually the agreement will bind the American bank to keep on deposit a certain amount of cash funds from day to day, and daily advice will be sent it as to the size of the deposit in order that it may govern itself accordingly.

With regard to the payment of interest by the London correspondent, the practice again varies. Where a minimum balance is required by the terms of the correspondent agreement, it is usually stipulated that interest shall be paid only on that portion of the deposit which is a surplus over and above this minimum; where no minimum is required, interest is ordinarily allowed on the entire balance, or on the daily average. This appears to be, and is, an unequal treatment of the two classes of American banks, for in the one case the London bank is allowed the use of a certain sum of money without interest charge, while in the other any profit made from the balance must be derived from a difference between the rate of interest allowed the American bank and the rate at which the balance can be employed in the London money market.

However, some compensation is usually made for this inequality by the practice of allowing those banks which have the harder terms in regard to the interest payment a somewhat lower scale of commission charges on the services rendered by the London correspondent.

Whatever the agreement as to the proportion of the balance which shall be interest-bearing, the *rate* paid is the same for all banks. It is set at a common point by the practice of the money market of London, and called the *deposit allowance rate*. In normal times, the deposit allowance rate is fixed one per cent below the published discount rate of the Bank of England, but this relation between the two rates cannot be expressed as a hard-and-fast rule, for the reason that, although the Bank of England rate rises to high figures in times of money stringency, the deposit allowance rate does not rise above four per cent, except in rare instances. We may say that, when the Bank of England rate stands at five per cent or below, the deposit allowance rate will be one per cent lower; but, when the former raises above five per cent, the latter will probably remain at four per cent.

73. The acceptance account. We have already discussed, at different points in the preceding pages, the terms usually agreed upon by the two correspondent banks to govern the acceptance account, and need do no more here than bring this information together in a convenient summary. The purpose of the acceptance account is to engage the services of a London bank as acceptor of bills which it is the duty of the American bank to redeem at maturity; accordingly, the agreement between the two banks will be such as to subserve this purpose. The London bank agrees to do the following things:

- (a) To accept all sterling long bills drawn by the American bank or under its authority, provided it has received advance notice of the drawing. A limit is usually set to the amount of the acceptances which may be outstanding at a given time, though, in rare cases, the maximum is left entirely to the discretion of the American bank.

- (b) To redeem these acceptances as they mature, out of the balance of the American bank.
- (c) To handle all documents which may accompany these bills under instructions from the American bank.
- (d) To send out a formal confirmation notice to the beneficiary of a letter of credit, when so instructed.

For its part, the American bank is bound to perform the following duties:

- (a) To advise the London correspondent in advance on each occasion of the drawing of a sterling long bill for acceptance, or the issuing of a letter of credit which empowers another party to draw them.
- (b) To make advance deposits to the credit of its cash balance in time to redeem all acceptances.
- (c) To supply collateral security, usually in the form of first-class stocks or bonds, to the amount of the maximum to which it is allowed to draw against the acceptance account. This provision has the effect of guaranteeing the performance by the American bank of its obligation to redeem the acceptances. The deposit of collateral is not always required, but the cases where it is waived are the exception to the rule.

The acceptance account, itself, is a bookkeeping device for recording the liabilities of the American bank on account of acceptances performed by the London correspondent. As each sterling bill is presented for acceptance, its amount and the date of maturity will be recorded as a charge to the acceptance account; usually, also, a duplicate of the bill will be kept in the portfolio of the bank. As the acceptance matures and is presented for encashment, it is paid from the cash balance of the American bank and the amount removed from the acceptance account by recording a credit. At any given time, therefore, the balance of the acceptance account will disclose the number of acceptances outstanding and the dates upon which they mature; thus exhibiting the liability of the American bank for future remittances of cash items as cover for the acceptances. If duplicates are kept, these are arranged in the portfolio according to maturities so as to show at a glance

the total number of bills which the American bank is obligated to redeem at certain future dates. As has been said, the London bank in most cases stipulates that the value of the acceptances outstanding must not exceed a certain maximum at any given time. The exact amount of this maximum is usually determined with reference to the average cash balance which it is the custom of the American bank to keep, for it is upon the sufficiency of this balance that the London bank depends for its ability to redeem the acceptances at maturity. The maximum is of the nature of a "revolving fund"; that is, as acceptances are retired, their amount becomes once more available for the drawing of sterling bills by the American bank, but when the maximum credit has been reached, drawing must stop until some of the outstanding acceptances have reached their term.

74. Commission charges of London correspondent banks.

A London correspondent may possibly derive an income by employing the cash balance at a higher rate of interest than the allowance rate granted the depositing banker. Furthermore, it may have in its possession a certain amount of cash funds upon which no interest is paid and may derive a profit from this addition to its supply of working capital. In the main, however, it is not upon these sources of profit that the London bank relies for its remuneration for the services rendered its foreign correspondents, but upon a predetermined schedule of commission charges to which both bankers have agreed. There is little uniformity in this scale of commissions. In some cases the commission principle is discarded entirely, and the American bank is charged a certain annual fee proportional to the amount of business expected; but this is rare. When the remuneration is determined by the commission principle, the agreement may take either of two forms: (a) a flat percentage charge on all business passing through the hand of the London bank; (b) a list of services for which commission will be charged, together with a percentage charge peculiar to each kind of service. In the first case, the amount charged will vary inversely with the volume of business, thus giving preferential treatment to the larger correspondents. The

average rate is probably about $1/8$ of one per cent; but this average has little significance for the rate is sometimes set as high as $1/4$ per cent, and sometimes as low as $1/32$ per cent.

Under the second method of determining the commission charged by the London correspondent, the services for which a charge is made are the following:

- (a) The acceptance of bills for the American bank. The commission is adjusted to the life of the acceptance, being stated as a percentage of its value per month of its life. The act of acceptance makes the bill the legal obligation of the London bank regardless of performance or non-performance by the American bank of its duty to supply the funds for its redemption. In a sense, therefore, the accepting bank is risking its funds against the chance of insolvency of its correspondent, or of financial disturbance in the correspondent's market which may render the correspondent temporarily unable to perform its part of the acceptance agreement. This risk is to some extent dependent upon the length of life of the acceptance; hence, the practice of proportioning the commission charge to the usance of the bills. The percentage varies for different banks, but is usually either $1/8$ or $1/16$ per cent per month. It should be understood that this charge applies to bills drawn by the American bank as well as to those drawn by foreign exporters under the authority of a sterling letter of credit.
- (b) The caring for documents attached to commercial bills of all kinds. These documents must be examined to determine whether they conform to the instructions of the draft, and then be detached and delivered to the drawee either upon acceptance or upon payment or prepayment. In many cases, the American bank allows the correspondent freedom to use its discretion in handling the documents, though, more frequently, it is understood that the London bank will act only under orders. Caring for the documents involves the drawing up of trust receipts, the warehousing of goods, and many other

details which may become necessary when goods are imported into England. The rate charged is usually very small. Perhaps $1/32$ per cent on the face of the bill is a typical rate.

- (c) The disposal of merchandise seized because of default on the part of the drawee of the commercial bills. It will be recalled that the American bank in buying a commercial bill is given first lien upon the goods as collateral security against failure of the importer to redeem the draft. The buying bank will not place great reliance upon this collateral because of the bothersome and expensive transactions necessarily connected with the sale of wares by an institution for whom commercial operations are foreign to its business; and the seizure of the goods will not, in any case, release the drawer from his liability to make good any loss on the bill. When necessary, however, the seizure of the goods will be accomplished by the London correspondent, who will await further instructions before proceeding with the sale. The American bank will then communicate with the drawer of the bill, allowing him the choice of having the goods returned at his expense or of attempting another sale in the English market. If neither of these alternatives is adopted, the London correspondent will be instructed to sell the shipment, the usual method of procedure being to turn the entire lot over to some broker to be disposed of at the best terms available in the market. The brokerage charges will be paid out of the American bank's balance and added by the latter to the amount which it recovers from the drawer of the dishonored draft. The commission of the London bank is separate from these brokerage charges; again, the rate cannot be stated definitely, though a charge of $1/16$ per cent is not uncommon.
- (d) Confirmation of a letter of credit or of any bank credit. The act of confirmation will not be performed unless positive instructions are received from the American bank to that effect. The confirmation increases the liability

of the London acceptor, since it gives the beneficiary of the letter of credit the legal right to exact the performance of acceptance on all bills drawn in conformity with the terms of the letter of credit; without confirmation, the liability of the London bank would lie solely between itself and the American correspondent. A charge is properly made for the increased liability caused by the confirmation, and this expense is passed on by the American bank to its client in the form of a higher charge for a confirmed than for an unconfirmed letter of credit. The commission for confirmation is usually about $1/8$ per cent of the face of the bill, though this rate, like all others, varies widely between different banks.

- (e) The cashing of drafts drawn under a traveler's letter of credit and of travelers' checks in case these are issued with fixed conversion rates upon their face. The checks are, of course, redeemed out of the cash balance of the American correspondent. A charge is not always made for this service, and where made is at a very low rate, something like $1/32$ per cent.

75. The London discount market. The correspondent relations just discussed are sought by American banks and the banks of other countries so that they may be enabled to conduct certain operations in sterling exchange, operations made profitable by the commanding position enjoyed by sterling bills in all the exchange markets of the world. One powerful factor making for this supremacy of sterling exchange has been the ease with which long bills have been discounted after acceptance in the money market of London. In many of the transactions carried on by the correspondents of London banks, the discounting of the sterling bill is an essential step, so essential, in fact, that the transaction would fail of its purpose if the discounting of the bill should prove impossible.

For example, the finance bill drawn by an American bank and accepted by its London correspondent is created for the sole purpose of enabling the drawee to make a short-term loan in the New York market; it is, however, foreign to the

intention of the two correspondents that either of them bear the burden of this advance, for the finance bill will be discounted immediately upon acceptance, and so absorb a part of the loan funds of the London market. Similarly, all the negotiations which lead up to the drawing of a sterling long bill under a commercial letter of credit hinge upon the discounting of this bill in London. The exporter is to receive his money as soon as his goods are shipped; the importer is not to pay until a later date; neither of the correspondent banks involved in the issue of the letter of credit contemplates making the advance of funds which this situation implies. But there are lenders of money in the discount market of London willing to advance funds to finance just such transactions as this, and the exchange operations are calculated to create a credit instrument which makes these funds available for the use of the two merchants.

In brief, it may be said that, whenever a sterling bill of exchange is expected to discharge a financing function, the discount market of London is essential to the consummation of its purpose, excepting those transactions in which it is the intention of the banker who buys the bill from the drawer to retain it as an investment. In these cases, it is the buying banker who chooses to make the advance of funds, and he will hold the accepted bill off the discount market in order to obtain for himself the increase in value which will accrue as maturity is reached. But it is obvious that the banker will not choose, in this manner, to invest in a sterling long bill unless loan funds are cheaper in his own market than they are in London, for the bill will earn interest at the London rate, and, unless this rate is the higher of the two, the banker will be choosing the less profitable of two alternative uses for his funds. Since it is rarely true that the London discount rate rises above that of other financial centers, by far the greater proportion of sterling long bills, bought by the exchange bankers of other markets, are sold in the open market of London after acceptance has been secured upon them.

A few words in further description of these bills in which the

discount market of London deals. They are, of course, always acceptances, for a bill of exchange unaccepted has not yet acquired the character of a binding obligation of the drawee and so has slight investment value. Furthermore, they are, for the most part, the acceptances of banks or finance houses. The reason for this has been disclosed in our discussion of sterling commercial long bills. Trade bills, the acceptances of merchants, are in the majority of cases taken by the bankers for collection only, and do not represent an advance of funds to the exporter, since they are not discounted at any stage of their existence. Those trade bills which *are* bought by the bankers are almost always documented, and carry the instructions, documents against payment. Since these bills cannot be separated from their documents if they are discounted in the open market, they make a credit instrument somewhat difficult to handle. But the most effective bar to the discounting of payment bills is the acceptor's privilege of prepayment at any time before maturity, a privilege made operative by the custom of the London market against any holder of the acceptance. The enforcement of this privilege requires a record of the history of the acceptance, and this involves in a system of red tape any attempt to transfer the bills from hand to hand in the open market; moreover, an investor in them is always in doubt as to the date of maturity of his assets. For these reasons they are not discounted.

We have thus eliminated all trade bills taken for collection and all payment bills; there remains only that small portion of trade bills which are drawn against houses of the highest international reputation and carry the instructions, documents against acceptance. These are bought by bankers and are discounted in the London market. Bankers' acceptances and the acceptances of these merchants of superior credit rating, all of them clean bills, comprise the exchange instruments in which the London discount market deals. We shall now proceed to examine the mechanism of this market in its relations to the business of foreign exchange. Its agencies fall into four divisions (a) the private and incorporated banks of

London, including the London offices of foreign banks; (b) the bills brokers; (c) the discount houses; (d) the Bank of England.

76. Relation of the London banks to the discount market.

The commercial banks of London hold a twofold relation with the discount market, being at the same time the greatest source of supply of acceptances for the other money-lenders, and themselves the discounters of a part of this supply of acceptances. As correspondents of foreign banks, it is an ordinary phase of their business to receive sterling bills from all quarters of the world, present them for acceptance to their drawees, and offer them for sale in the discount market. The bill brokers and other dealers in the open market find in this continuous stream of acceptances an immense field of investment opportunity, and they, accordingly, depend upon the banks for daily supplies of commercial paper which they may buy and hold until maturity. But the banks themselves are primarily credit institutions, whose normal function, like that of the banks of discount and deposit in America, is to lend cash and credit on the security of commercial paper of all sorts. The accepted bill of exchange, as a credit instrument, possesses elements of superior attractiveness. It is usually drawn for a short term; its security is of the best, especially when the acceptor is a bank; and it enjoys a broad market in which it can be easily resold in case of emergency. Consequently, it appeals to bankers whose assets must be both secure and liquid, and so it is not at all strange that a large part of the acceptances which pour into the London money market should be taken up by the bankers themselves and carried for their own account.

The bills of exchange bought by the London bankers are drawn principally from two different sources. In the first place, these banks, as correspondents of banks in other centers, are daily handling a mass of sterling bills sent over for acceptance and discount. The instructions which accompany these bills usually require that the acceptance be sold immediately in order to recover the money invested by the foreign bank by the act of purchase. Such instructions bind the Lon-

don correspondent to dispose of the acceptance and credit the cash balance of the foreign bank with the proceeds, but leave him free to exercise his function as money-lender and buy the acceptance at the same rate of discount that would apply to it in the money market. Indeed, one of the advantages which the London banker derives from his position as correspondent is this power of selection over a great variety of credit instruments placed in his hands by the banks of many foreign cities; his duty demands only that he credit his foreign client with the discounted value of the instrument, leaving him free to choose for his own uses those which best suit his purposes. The second source of supply upon which these banks depend is afforded by the bill brokers of the market who act as middlemen among the bankers. These brokers deal with the London banks both as buyers and as sellers of acceptances, investing in those acceptances which most appeal to them and offering to other banks a wide range of selection over the different items which they have bought.

It is essential to good banking practice that the instruments which comprise the bank's assets should be so arranged as to provide a continuous stream of maturities from day to day. This end will not be achieved without conscious manipulation of the commercial paper which fills the bank's portfolio; for, otherwise, gaps are sure to appear between the maturities, causing the liquidation of credit instruments to concentrate upon certain dates, and thus impairing the liquidity of the assets and throwing the bank open to the risk of insufficiency of cash upon the days when few maturities occur. The bill brokers provide a very useful offset against this condition by offering the bankers daily a large number of acceptances of various maturities from which to choose those which fit the needs of each banker's assets. This gives the bankers opportunity to invest their excess cash in such a way as to improve the liquidity of their commercial paper. The bankers' buying price, in each instance, will be governed by the ruling rate of discount in the open market for the class of paper in question.

77. The bill brokers and discount houses. In its customary meaning the term "broker" signifies an individual who acts

as go-between bringing buyer and seller together, investing no capital of his own, but drawing an income in the form of fee or commission for his services. It is probable that the bill brokers of the London discount market originally performed only this function of go-between, but if so, they have in recent years lost their original character and become investors on their own account. The brokers and the discount houses together form the backbone of the discount market of London, absorbing a major share of all acceptances which enter the market.

The bill brokers are not incorporated banks, but private individuals operating with capital a large part of which they borrow for short terms from the joint-stock banks of the market. They limit their operations almost entirely to the purchase and sale of bills of exchange, do not accept deposits or lend upon ordinary commercial paper, but take up the acceptances which the London banks offer for sale and hold them until maturity or resell them at a previous date if it becomes advisable to release the money invested in them. The relation of the brokers to the London banks, as disclosed in the preceding section, is somewhat peculiar; they borrow from the banks at low rates and for short terms against a deposit of collateral made up of "prime" acceptances, Government bonds, and other first-class credit instruments; they then buy accepted bills from these same banks with the money they have borrowed from them; finally, they sell back to the banks at a more favorable rate a portion of the acceptances which they have bought from them. Over a large share of the acceptances which they buy, they retain permanent ownership, usually carrying them as collateral against their loans. Whenever it becomes necessary to reduce their loans at the bank, they rediscount these acceptances, passing them over to the discount houses, or to the banks, or, finally, to the Bank of England. By these operations, they build up a broad market for accepted bills of exchange, and their presence in London accounts in large measure for the ease with which that market absorbs the immense flood of sterling bills which daily pours into it.

The complexity of the relationship between the London banks and the bill brokers requires further explanation. In all financial centers, the banks carry a large part of the liquid reserves of the outlying country districts, reserves which must be invested carefully so as to allow almost immediate liquidation in case any emergency requires that they be turned into cash. Loans at call secured by negotiable instruments of the highest order afford the most eligible method of investing such funds. In New York, these call loans have been made for the most part to the brokerage houses dealing on the Stock Exchange and have been secured by the stocks and bonds in which these borrowing houses deal. But in London the practice of fortnightly settlement on the Stock Exchange debars most operators from contracting call loans against a deposit of stocks and bonds. This releases the liquid funds of the banks for the use of bill brokers whose collateral security consists in the main of the instruments in which they deal, namely, accepted sterling bills of exchange maturing at different future dates. A call loan so secured can, in normal times, be renewed from day to day and so can be relied upon to supply the broker with the funds needed to carry him through a prolonged series of operations. As the acceptances mature, they may be removed from the collateral deposit and others substituted for them, thus making of the deposit a sort of revolving fund into which may be placed the acceptances the bill broker is carrying until maturity, and from which may be withdrawn those needed for redemption or rediscount. In times of money stringency, however, the banks call in these loans, thus forcing the brokers to rediscount in bulk — usually with the Bank of England — the acceptances which have been serving as collateral, in order to return the money originally borrowed. In addition to the funds raised by means of call loans, the bill brokers possess a working capital of their own which supplies them with a number of acceptances apart from those serving as collateral, and these they may sell whenever a favorable opportunity appears, or may substitute for those in the collateral fund if any of the latter better serve the requirements of their customers.

The long experience of the bill brokers equips them as experts to analyze the qualities of the various grades of sterling acceptances which appear in the London market and to adjust their rates of discount to the quality of the bill with great precision in each instance. It is their daily business to make a circuit of the London banks, examine the acceptances offered for sale, take up any they may choose to buy, and at the same time to offer to each banker an opportunity to purchase upon stated terms any bills already in the brokers' portfolios. The prices offered by the brokers as buyers of bills establish the ruling rates of discount for the London market as a whole; the bills are classified according to security and length of life, and keen competition among the brokers determines for each class the peculiar rate of discount which it will command in the open market. The entire schedule of rates coheres about the rate for "prime bankers' acceptances," and this may be called the *open market discount rate* for bills of exchange. It is this governing rate to which reference is made in all statements which speak of *the* rate of discount in the London market; in reality, instead of a single rate, it is a system or schedule, the lowest applying to prime acceptances of bankers, the others ranging higher according to the qualities of the bills to which they apply. The correction of this schedule of rates from day to day is left to the free competitive action of the bill brokers and discount houses, for they alone, of all the money-lenders in the market, limit their activities to the purchase and sale of bills of exchange, and hence through them the play of demand and supply produces a rate which will clear the market.

The open market rate of discount is employed by the bankers when they buy for their own account any of the bills placed in their hands by the bankers of foreign cities; hence, these foreign correspondents can rely upon receiving the same prices for their bills regardless of whether the buying is done by their London agents or by a broker in the open market. However, when acceptances, bought by the brokers, are resold to the banks, it is the practice of the London market to allow a slightly lower rate of discount. This, of course, does not mean

that a bank will buy back at a higher price a bill which it has itself sold to a broker, but virtually the same result is reached; for the banks which have sold bills to the brokers at a certain rate of discount will buy other bills on the same day at a lower rate. To illustrate, a given broker may purchase from a bank on a certain day an acceptance for ten thousand pounds running for sixty days at a rate of 4 per cent, and immediately sell the same acceptance to another bank at a discount of $3\frac{3}{4}$ per cent. The broker's buying price, determined by the higher rate of discount, will, of course, be lower than his selling price determined at the lower rate. The difference in the brokers' favor between the rates at which the banks buy and sell bills when dealing with them is not always as great as $1/4$ per cent, sometimes falling as low as $1/16$ per cent; but even this small concession is sufficient on a large turnover to produce a considerable and continuous profit for the brokers.

The question may arise, Why do the bankers thus favor the brokers in their dealings with them? The reason is to be found in the fact that bills of exchange in passing through the brokers' hands gain in desirability from the point of view of the bankers, with the result that the acceptances which the banks buy from the brokers are worth more than those which they sell. The activities of the brokers increase the desirability of the acceptances in which they deal in two ways. In the first place, the fact that a banker decides to sell an acceptance rather than invest in it for his own account is evidence that that particular bill does not fit his needs; its amount may be too large, or it may bear the name of an acceptor whose obligations the banker already holds to an extent as large as prudence will allow, or its date of maturity may not fit in with the sequence of maturities in his portfolio. The acceptance which the banker buys from a broker will be selected with all these requirements in mind and will, therefore, be a more attractive investment instrument and worth a higher price. Viewed from this standpoint, the transactions between brokers and bankers in the market as a whole have the effect of passing over a great mass of miscellaneous bills to the brokers, to be assorted and redis-

tributed among the bankers according to the requirements of each. This is a distinctively middleman's function and is worth the remuneration it commands.

There is a second reason why a bill of exchange grows in desirability as a credit instrument in passing through the brokers' hands. Credit instruments are ordinarily transferred by endorsement from one holder to another, the act of endorsement adding to the security of the instrument by increasing the number of contingent guarantors. Now, the bills of exchange which are sent over to the London market are usually endorsed *in blank* by the foreign banker who buys them from the drawer, and this makes them transferable without further endorsement; nevertheless, it is the practice of the market to require some form of endorsement from the brokers when these bills are resold by them to the banks. This endorsement is not often placed upon the acceptance itself, but the same end is reached by means of a contract given by the broker to each banker with whom he rediscounts bills, guaranteeing the redemption of all items sold by the broker at any time. Consequently, when a broker sells an acceptance its security is somewhat better than it was at the time he bought it, and the bankers may properly take account of this fact in adjusting the rates at which they deal with the brokers.

The *discount houses* hold a place in the London market very similar to that of the bill brokers; both make it their principal business to discount acceptances. There are, however, certain distinctions between these two groups of money-lenders, both in function and in form of organization. We have seen that the bill brokers are primarily middlemen; though they carry some of the acceptances which they buy until maturity, thus making an extended investment of funds, it is ordinarily their intention to rediscount all of their purchases whenever they can obtain favorable rates. The discount house, on the other hand, is much less a middleman and more a financing institution than the broker; when an acceptance has been bought by the discount house, it is usually retained until maturity. Furthermore, the two differ in form of organiza-

tion; the discount house is much like a commercial bank, supplying a relatively large part of its working capital, accepting deposits upon which it pays interest, and engaging to some extent in investment business apart from its purchases of acceptances. In addition to the capital contributed by the shareholders or partners in the discount house, or received from its depositors, working funds are borrowed on short terms against deposits of collateral security, as is the case with the brokers. Almost the whole of this capital is invested in bills of exchange of various maturities; the combined assets of the discount houses of London are large enough to remove from the market a vast amount of acceptances.

78. The Bank of England. This great institution is the cornerstone of the London market, not by virtue of any official power which it wields, but because of the nature of its relations with the other money-lenders, the reliance which they place in it, and the influence which it may exert over the rates of discount which rule the market. It is a private institution, distinguished by the fact that it is banker to the British Government, is custodian of the cash reserves of the City and provincial banks, and conducts its operations with a view, primarily, toward the public interest. The Bank is made up of two distinct departments: the Issue Department, whose sole function is the issue of notes against prescribed security and the redemption of these notes in gold on demand; and the Banking Department which engages in a general banking business. It is with the latter that we are concerned in our study of foreign exchange.

The banking department of the Bank of England deals with its own clientèle in the business world, as does any other commercial bank; but a large share of its transactions are carried on with other bankers in England. As custodian of the cash reserves of other English banks, the Bank of England carries huge current deposits which must be so invested as to be kept in a highly liquid form against any emergency which may necessitate an increase in the cash resources of the depositing banks. From its own capital, the deposits of its business clientèle, and the cash reserves of other English banks,

the Bank is supplied with a loan fund of great magnitude. Its principal function as a credit institution is that of *rediscount*, and it is in the performance of this function that the Bank comes in contact with the discount market and exerts its influence over the dealings in bills of exchange which the market carries on. The Bank buys only those bills of exchange which have been accepted by English drawees and are payable in England, and it buys none of these in the open market; that is to say, it does not purchase acceptances generally from their first sellers, as do the brokers and discount houses, but takes them by rediscount from those of its own customers who have bought them in the first instance. To become regular clients of the Bank, and so to avail themselves of its services of rediscount, the brokers and discount houses of London carry their deposit accounts with the Bank of England. From these two sources are drawn the acceptances in which the Bank invests; thus each bill in the possession of the Bank bears the names of two English houses: the acceptor and the endorser (bill broker or discount house) who first bought the bill after acceptance and has resold it to the Bank. There is nothing in the law or policy of the Bank of England to prevent the joint-stock banks of London from rediscounting with it any of the bills which they hold, but custom and tradition have decreed that these institutions retain possession of all the acceptances they buy, it being considered a sign of financial instability for these banks to resell any commercial paper in which they have once made an investment. Hence, the rediscounting of the Bank of England is done for bill brokers and discount houses, and not for the great incorporated or private banks of the city.

The essential purpose of a central agency of rediscount, such as the Bank of England, is to provide for other banking institutions a method of relief whenever the percentage of their cash resources to demand liabilities becomes dangerously low. During a period of credit expansion, the banks of any money center rapidly increase their holdings of investment instruments, especially the commercial paper used to finance the increasing transactions of the business world, at the same

time multiplying the deposit liabilities which are payable on demand. While this process is under way, the proportion of cash reserves to other less liquid assets of the banks shrinks toward the point where danger will arise of an insufficiency of cash to meet the demands of the banks' creditors. If, at such a time, no method is available whereby the banks can liquidate a part of their assets, further lending must stop, greatly to the detriment of the business world which relies upon a continued extension of credit to finance operations already begun, until the gradual maturing of the commercial paper held by the banks restores the balance between cash and slow assets. This stoppage of lending may be sufficient, in times of unusual stress, to precipitate a panic and a general breakdown of the credit structure of the market. The relief afforded by a central agency for rediscount is of supreme importance at such times, for to this central institution the banks may sell a part of their commercial paper and thus strengthen the condition of their cash resources without adopting the violent expedient of calling a halt to their lending operations.

In the London market, the Bank of England stands as an ever-ready source of relief in times of credit stringency; its own lending operations are carefully limited in normal periods that it may hold in reserve a vast power to rediscount the assets of other credit institutions whenever the emergency arises; and during its long history it has never failed to supply the funds required for the relief of the money market. Its support of the London banks as a rediscounting agency is none the less effective despite the fact, mentioned above, that these banks are forbidden by custom directly to rediscount any of their assets with the Bank of England even in times when their credit is extended to a point of danger; for, as we shall see presently, these banks obtain by indirection and in a somewhat roundabout way the relief which business custom forbids them to seek directly.

To illustrate the functioning of the Bank of England as a rediscounting agency, let us assume that a flood of acceptances has been pouring into the London market in increasing volume for a considerable period of time. A part of these ac-

ceptances will have been bought by the banks for investment on their own account; another part will have been absorbed by the bill brokers and discount houses and withdrawn from the market; still another, and a large, part will be carried by these money-lenders as collateral security for call loans with which to supply the funds for their dealings in the open market. A time comes when the loan funds of London are extended to their full capacity, and additional discounting of acceptances becomes difficult. The bill brokers and discount houses, who rely upon the readiness of the banks to rediscount acceptances, find that these banks are refusing to add to their holdings of commercial paper; unless they can dispose of the bills they already carry, the brokers and discount houses will have reached the limit of their power to discount the sterling acceptances which appear on the London market. It is then that they turn in large numbers to the Bank of England, rediscounting there the bills of exchange which normally would be taken off their hands by the other banks of London.

At the same time, the banks of the city are very probably laboring under the necessity of liquidating a part of their assets in order to strengthen the loan funds which have been drained away during the period of credit expansion. Though they do not rediscount directly with the Bank of England, as do the brokers and discount houses, these banks adopt expedients which virtually accomplish the same result. Among their assets are the call loans of the brokers and discount houses, supported by collateral in the form of acceptances, and of all their assets the call loans are the most available for liquidation. Accordingly, the banks call in a portion of these loans; the borrowers cannot repay them without first having disposed of the collateral upon which they are based, and, under the conditions which obtain at the time, they have but one means of disposing of this collateral — by rediscount with the Bank of England. They sell the acceptances to the Bank, have the proceeds placed to their credit, and against this credit draw checks for the amount of the loans which they are under obligation to repay to their own bankers; the checks are deposited by their bankers in the Bank of England, thus

swelling the cash reserves which the banks carry in that institution and accomplishing the end which the banks had in view when calling in their loans: namely, to turn a part of their paper assets into cash so as to increase the proportion of reserve to demand liabilities. By this roundabout process, the London banks compel their clients to do what they do not care to do themselves; that is, to avail themselves of the rediscount function of the Bank of England when it becomes necessary to liquidate a portion of their assets.

When all the credit institutions of London are turning to the Bank of England in this manner, the Bank is obviously placed in a strategic position from which to make its influence felt throughout the entire money market. Clearly, a refusal of the Bank to rediscount will put an effectual stop to the further sale of acceptances in the open market; furthermore, the terms which the Bank chooses to exact when rediscounting for the money-lenders must govern them in setting the rates at which they continue their dealings in bills of exchange. Now, the Bank of England has never actually refused to rediscount, though there is no law, aside from long standing custom and the care of the Bank for the public interest, to prevent such refusal. However, the Bank is free to establish its rate of rediscount at any point which it thinks advisable, thus determining the purchasing rates of other dealers in the exchange market and, accordingly, the ease or difficulty with which sterling acceptances may be sold. At such a time, the published rate of the Bank of England is an effective governor of all the discount rates of the open market, for the reason that the operators in the market are forced by the exigencies of the situation to obtain the funds with which they do business by paying this rate to the Bank of England; and, of course, they cannot carry on their transactions as lenders without regard to their costs as borrowers. This opens for us the important subject of the influence of the Bank Rate on the discount market and the factors which make this rate effective.

79. The position of the Bank of England Rate in the London market. We have called attention above to the fact that "the market rate of discount" is not, in reality, a single rate, but a

group of rates applying to bills of varying maturity and term of life. When the expression *the market rate* is employed, reference is had to the lowest rate of the system; that is, to that rate at which prime bankers' acceptances of sixty or ninety days' usance are bought in the open market of London. This class of acceptances is superior to all others, and, consequently, the terms it commands are more favorable. The other rates in the system range above this minimum in the degree to which the other classes of bills contrast as investment instruments with the premier quality of bankers' acceptances. The spacings between the different rates in the system, however, are always fairly fixed and constant; the whole group moves in a body in the same direction whenever the conditions of the loan market are such as to cause a rise or fall in the rate of interest. When we speak, in the discussion which follows, of the relationship existing between the market rate of discount and the Bank Rate, it must be understood that the former of these expressions is used in its customary meaning with reference to the price offered in the open market of London for prime bankers' acceptances.

It is the practice of the directors of the Bank of England to make public every Tuesday the rate at which the Bank is prepared to discount prime bankers' acceptances for the following week. This is the *Bank Rate*, formally known as "The Official Minimum Discount Rate of the Bank of England," widely quoted by financial papers the world over, and accepted by all financial institutions as an index to the condition of the London discount market. In normal times, this rate is maintained at a figure which is fairly regular from day to day and week to week; in times of approaching money stringency, however, it is advanced to higher levels, reflecting the exhaustion of the loan funds of the money market; and it is then that the behavior of the Bank Rate is watched with closest scrutiny by the financial interests. The observation of men whose business brings them in contact with the money market of London has shown that a relationship exists between the Bank Rate and the discount rates of the market, and that this connection is especially close during

those periods when the Bank Rate is rising. Just what the relationship is, however, and how it is brought about, is not often clearly understood. As a matter of fact, the causal connection between the two rates is not simple and uniform, for sometimes the Bank Rate is the effect, sometimes the cause, of the market rate of discount.

✓ The degree of influence exerted by the Bank Rate over the discount rate of the open market at any given time may be said to depend upon whether the bulk of the Bank's business, at that time, consists of *discount* or *rediscount* operations. Like every commercial bank, the Bank of England carries on the customary transaction of discount and deposit, taking up the promissory notes of its clients and creating deposit or checking accounts in favor of the borrowers. In conducting this business, the Bank of England enters into competition with the other London banks, establishing direct relations with the business men of the city and extending credit for the use of these men in their ordinary commercial transactions. During those periods when the loan funds of the London market are abundant, the business of the Bank is principally of this sort; the other banks can supply from their own resources the funds required to conduct their credit transactions and are not forced to resort to the Bank of England for aid. Hence, comparatively little rediscounting is done by the Bank, and its published Rate, since it does not determine the cost at which the brokers and discount houses obtain their funds, cannot control the rate of discount which rules the market.

During these periods it is the practice of the governors of the Bank to base the Official Rate upon the rate of discount for prime bankers' acceptances which the uncontrolled forces of supply and demand establish in the market, setting the Bank Rate a fraction of one per cent higher than this open market rate. But this Official Rate at such times is largely a formality; the Bank itself does not use it for the conduct of its own business, but in its negotiations with its clients offers better terms of discount, terms which conform to the rate at which the other banks of the city are doing business. The formal character of the Bank Rate under these conditions

is clearly understood by the other money-lenders of the market; indeed, its significance at such times inheres in the fact that it *is* a formality, for it stands as evidence that "money is easy" in London, that there is a large reserve of potential credit upon which business men can rely for financial assistance. When the money-dealers of the London market are able to absorb the supply of commercial paper which enters the market, without resort to the rediscounting function of the Bank of England, the statement is very properly made that the Bank Rate is not *effective*, the meaning being that it exerts no influence over the rates at which bills are discounted by brokers, discount houses, and other bankers. Its relation to the market rate of discount is then not that of cause, but of effect.

But the situation is reversed during times of money stringency when the Bank begins to exercise its function of rediscount. We have seen how, in such times, the brokers and discount houses are driven to the Bank for relief from a part of their load of commercial paper, and how their dependence upon the Bank gives it power to influence the rates at which business is done in the open market. It has long been the practice of the Bank of England, by limiting its discount operations during periods of financial quiet to a fraction of the amount made possible by its vast resources, to save its lending power for use in such emergencies. When rediscounting begins, this lending power is called into play to absorb a part of the commercial paper of the brokers and discount houses and so, indirectly, to strengthen the credit of the other banks of the city. But rediscounting has the effect of reducing the proportion of the Bank's reserve to its liabilities, and, if it continues long enough, will place the Bank of England in the same condition of strained credit which temporarily characterizes the other banking institutions of the London market. It is necessary then to place a check upon the lending operations of the entire market, not, indeed, by means of a sudden and violent cessation of loans, such as must take place in the absence of a central agency for rediscount, but by discouraging unnecessary borrowing and making loans diffi-

cult to get. The Bank does this by raising the Official Rate point by point as its reserves fall. This makes it increasingly expensive for the brokers and discount houses to rediscount with the Bank of England and causes a progressive rise in the rates at which they conduct their transactions, which, in turn, reduces borrowing and checks the credit expansion. In other words, the Bank Rate becomes *effective* as a governor of the market rate of discount, and the governors of the Bank are given the power by the exigencies of the situation to determine more or less at will what prices bills of exchange and other commercial paper shall command in the open market. They use this power to restrict credit operations in London and so prevent an overexpansion which might result in a collapse of the credit structure of the market.

CHAPTER XIII

THE LONDON MARKET (*continued*)

80. The Bank Rate and the flow of gold. In the preceding chapter we have examined the mechanism of the London discount market and described the dominant position of the Bank of England with relation to it. We have seen how, in times of money stringency, the Bank can control the functioning of the discount market through its power to adjust the rediscount rate, and thus dictate the terms upon which the brokers, discount houses, and banks of the city buy and sell acceptances. It is our present purpose to take a broader view of this power of the Bank of England and inquire to what extent and in what manner the Bank can affect the relationship of the London market as a whole to the rest of the world.

In all countries using the gold standard, the uninformed majority of the people are prone to exaggerate the importance to the nation of the supply of precious metal; this common opinion is, as a rule, based upon incorrect notions concerning the nature of money, and is to a large degree fallacious. Yet there is a modicum of truth in the error. Nations whose monetary and credit structure is founded on a gold standard cannot always view with indifference the ebb and flow of the gold stock; there are times when a continued loss of gold through exportation may threaten a depletion of the gold reserves of the banks and treasury to an extent which affects the stability of credit and, perhaps, even of the gold standard itself. At such times, it is of national importance to check or limit the outflow of gold, or to spread it over a period of time so that readjustment may be less violent and severe. Again, when credit operations of some magnitude are in prospect, it may be important to induce an inflow of gold which would not otherwise occur, or to hasten and concentrate an inflow which might otherwise be postponed and diffused. Moreover, in the past, these gold movements have been of peculiar concern to Eng-

land, since London, the greatest free gold market of the world, and the chief center of international credit, has been most susceptible to demands for gold from other nations and most concerned to maintain a sufficient gold reserve to ensure beyond all question the validity of her credit structure. In this setting, the position of the Bank of England with relation to the exchange market acquires additional significance; the Bank has had power, while maintaining without compromise its obligation to surrender gold freely to all *bona fide* creditors, to exert a decisive influence over the magnitude of the gold movements to and from England.

To make clear the basis of this power and to explain the method by which the Bank has brought it into play in times past, we must recall the condition of the exchange market which causes a movement of gold between nations. Speaking with reference to London, we may say that an outflow of gold will occur when the sterling sight rate in other markets has fallen to the specie importing point.¹ When the sterling sight rate in New York, for example, has settled to the specie importing point, New York will begin to draw gold from London; for at this quotation, the discount on bankers' demand drafts is so great that the loss to the bankers from converting their London credits into dollars through the sale of drafts is exactly equal to the expense of converting these credits by the alternative method of importing gold from London. At the specie point, therefore, it is a matter of indifference to the bankers whether they avail themselves of their London credits by continuing to sell sterling checks, or by instructing their London correspondents to ship the funds on deposit at the expense of the depositing bankers. A further decline of the rate, however slight, will suffice to turn the scale in favor of gold importation as an alternative to the sale of sterling sight drafts, and the result will be an outflow of gold from London.

Conversely, gold moves toward London when the sterling sight rate in other markets has risen to the specie exporting point. Let the quotation on sterling demand drafts rise to

¹ We refer here only to specie movements; commercial shipments of raw gold may occur under other circumstances.

this point in New York, and the bankers of that city will begin to send gold to London to place themselves in position to draw sight drafts for sale on the favorable market; for with so high a premium, they will gain enough from the sale of their drafts to offset the costs of shipping the gold with which the drafts are redeemed. Of course, not all bankers will be required to ship specie in order to take advantage of the favorable market; for some of them will have sufficient credit in London to meet the demands of their customers. But others, not in this position, will be tempted into the market as sellers of sterling exchange by reason of the extremely high rates and, lacking London credit, they will be compelled to place gold in the hands of their correspondents. The proximate cause, then, of movements of gold to and from London is the position of the sterling sight rate *in other markets*; hence, any power enjoyed by the Bank of England to prevent or to reduce an outflow of gold from London must be due to the fact that the Bank can prevent the decline of the sterling sight rate to the specie importing point in markets outside of England; while to induce or increase an inflow of gold, the Bank must in some way raise the sterling sight rate abroad to the specie exporting point. Our problem, therefore, is to discover wherein lies this power of the Bank over the selling rates of foreign bankers for sterling checks, and to examine the practical method of its exercise.

At the outset, we must lay down the rule that the quotation on sterling demand drafts in New York and elsewhere is controlled by the supply and demand of bankers' checks drawn on London, and by no other forces whatsoever. This rate falls to the specie importing point only when the supply of bankers' sterling checks is so large that, at any higher rate of exchange, the supply will exceed the demand. Not wishing to be left with unused sterling credits, the bankers will endeavor to encourage the sale of their drafts by offering them at lower rates until the quotation has fallen to the specie importing point; beyond this they will not go, preferring, as we have seen, to withdraw from the market and import gold. The decline of the rate, and the outflow of gold from London

can be restrained, effectually, only by bringing to bear on the New York exchange market an influence which will either increase the demand for bankers' sterling sight drafts or reduce the supply of them, or exert both of these effects at the same time. On the other hand, when the demand for bankers' sterling checks is in excess of the supply at lower quotations, competition among the buyers will produce an upward trend of the rates until the specie exporting point is reached, beyond which an unlimited supply of sterling sight drafts will appear on the market.¹ If, therefore, when the sterling sight rate in New York is hovering just below the gold exporting point, it is considered desirable in London to cause the rate to rise so as to induce an inflow of gold, this can be done only by increasing the demand for bankers' sterling checks in New York, or decreasing the supply of them, or both. This power to affect the conditions of demand and supply for sterling exchange in markets outside of England has been wielded by the Bank of England under certain favorable conditions.

Briefly stated, this power of the Bank of England inheres in its control over the discount rates in the open market of London. As we have seen in a preceding chapter,² this control is not absolute; sometimes the Bank Rate is the effect of the discount rate, sometimes the cause. It is only when conditions in London are such that the Bank Rate is *effective* in ruling the market, that the Bank of England can carry into effect any far-reaching policy looking toward restraining an outflow of gold from London or inducing an inflow. Hence, in the discussion which follows, it must be assumed that the Bank is actually in control of the situation during the period in question; that is to say, that there is a tightening of the credit supply in the market and the money-lenders are forced to avail themselves of the rediscounting function of the Bank. However, it is only in this state of affairs that the inflow or outflow of gold is likely to be a matter of concern to the money market of London; hence, we can say that, whenever a control over the

¹ If further explanation of the specie points is required, the reader is referred to the discussion on pages 64 f.

² See section 78.

gold movement is to a great degree desirable, the Bank will probably be in position to exercise such control. The expedient by means of which the governors of the Bank control the gold movement is merely to raise the Official Bank Rate and, indirectly, the discount rates of the open market. They have only to pursue this policy consistently — that is, to raise the discount rate high enough — and the effect will be to lessen the supply and increase the demand for sterling sight in other money centers, so that the sterling rates will rise above the specie importing point and the loss of gold from London will cease.

The discount rate in the London market is brought to bear upon the *sterling long bills* which the bankers in other centers buy and forward to London for acceptance and discount. The buying price for these long bills in New York and other markets is determined by the rate of discount at which they will sell after acceptance.¹ When the London discount rate rises as a consequence of an upward movement of the Official Rate of the Bank of England, the quotation on sterling long bills in New York will fall; that is, the spread between the sterling long rate and the sterling sight rate will broaden. The rising discount rate in London will not, it is true, at once affect the sterling sight rate in other markets — that rate which determines the movement of gold. However, it will exert a secondary influence over this rate, an influence which will become clear when we recall the methods employed by the bankers when handling sterling long bills.

These long bills may be thrown into two groups: commercial bills of sixty or ninety days' sight drawn by exporters on British firms or bankers; and bankers' bills of the same tenor, consisting largely of finance bills, drawn in connection with international lending operations. When commercial long bills are bought by bankers, it is usually with the intention of the buyers to discount them upon arrival in London and carry the proceeds to the credit of their foreign balances. This they do in order to be enabled to draw a corresponding amount of sterling sight drafts for sale in their own market. But the

¹ This is explained on pages 88 f.

buying bankers are not under obligation to discount the acceptances; they may choose to invest in them for their own account, holding them until maturity for the gain of interest. What their decision will be in this matter will obviously depend upon the attractiveness of the long bills as investment instruments, and this will depend, in turn, upon the position of the discount rate in London. If the discount rate is high, the value of a long bill at acceptance will be much below its value at maturity, and the gain of the buying banker will be correspondingly large, if he decides to retain the bill as an investment. How high the London discount rate must rise before bankers in New York, and other cities, exercise their option of holding sterling long bills for investment cannot be stated absolutely; for this will depend in part upon the interest rate in New York which determines the profit to be derived by the bankers from the alternative use of their funds. But this much is certain: it is possible for the discount rate in London to rise so high that bankers will, in the main, refrain from discounting their long bills; and the policy of the Bank of England in raising the rediscount rate will, in time, eventuate in this result. Now, the important point for our purpose is this: if the New York bankers *do* refrain from discounting their sterling long bills, they must also forego for a time the drawing of sterling sight drafts against these bills. The acceptance itself adds nothing to the foreign balance, and, if held off the discount market, will add nothing until maturity; in the meantime, the supply of sterling sight drafts in New York will be diminished and one factor making for a lower sterling sight rate will be removed.

The rising discount rate will also exert its effect upon the bankers' sterling long bill drawn in connection with a lending operation between the bankers of the two cities. The New York banker draws the finance bill at sixty or ninety days' sight upon his London correspondent, sells the bill in New York and employs the proceeds on short-term loans until required to redeem the correspondent banker's acceptance. The buyer of the sterling long bill is usually another New York banker who uses it as cover for his sight drafts drawn on Lon-

don. The supply of these finance bills, therefore, determines to a certain extent the power of New York bankers to offer sterling sight drafts on the market in New York, and any influence which operates to discourage the drawing of finance bills will also operate to reduce the supply of sterling sight drafts. Now, no finance bills are drawn on London unless the discount rate in that city is appreciably below the discount rate in the drawing market,¹ since the profit of the two bankers concerned in the transaction is conditioned upon this difference between the two rates of discount. Hence, when the Bank of England adopts a rediscounting policy which forces the market rate of London to rise, this policy will have the effect of preventing the drawing of finance bills in sterling by bankers in foreign markets; this, in turn, will prevent the buying of these bills as cover for sterling checks by other bankers and so will tend to diminish one of the forces which depresses the sterling sight rate toward the specie importing point.

In one other way, and by a somewhat more roundabout process, the rising discount rate of the London market tends to decrease the supply of sterling drafts in foreign markets. In normal times, the excellence of the London market as indicated by the low discount rates which prevail and the immensity of the loan funds which the market commands, attracts to that market the acceptances of bankers payable in foreign cities. These acceptances are sent to London for discount in preference to the money markets of their respective places of domicile because the relatively low discount rates of the former market give them a higher sale price at the time of acceptance. When, however, the owners of bankers' acceptances payable in francs or marks elect to discount them in London rather than in Paris or Berlin, they acquire sterling credits of which they must avail themselves by drawing sterling drafts for sale in their own markets. A rising discount rate in London will eventually destroy the profitability of this practice of discounting there the acceptances of foreign bankers, and will turn into other money centers a part of the

¹ This matter is explained at length on pages 149 f.

stream of bills which normally flows toward London. This diminution in the number of discount items forwarded to London will, in turn, reduce the power of foreign bankers to draw sterling bills, and, consequently, will tend to restrain the fall of the sterling sight rate.

We have discussed three effects of the high discount rate in the London market which coöperate to *decrease the supply* of sterling demand drafts in other cities. We shall now see that in two different ways the high rate tends to *increase the demand* for sterling sight drafts, and thus to reënforce the influence of the decreased supply upon the sterling rate of exchange. Considering again the matter of sterling finance bills, we recall that the lending operation is closed out when the drawing banker buys sterling sight drafts and forwards them to his London correspondent to cover the latter's acceptance. Now, many of these loans are not closed out at the term of the first bill, but extended. When this is done, the drawing banker, who is under obligation to redeem the original finance bill, draws a second long bill in sterling on the same correspondent, sells it in his own market and uses the proceeds to purchase the required cover. Though this action cancels the original finance bill, it does not terminate the loan; for the London correspondent no sooner discharges his obligation as acceptor of the original bill than he assumes the same obligation with respect to the second, and the New York banker remains, as before, under obligation to make a deferred remittance of cover to London. When the loan is extended in this fashion, the redemption of the original finance bill cannot be said to have made a net addition to the demand for sterling sight in the New York market, since the buyer of the second finance bill will have acquired power to draw checks on London equal in amount to those required by the drawer of the bill. On the other hand, when the loan is closed out, the drawer of the finance bill must buy sterling sight drafts without in any way increasing the power of the market to supply them; in other words, the closing out of the loan will result in a net addition to the demand for sterling sight.

Now, the decision as to which course to pursue when a

finance bill is about to mature in London — whether to close out the loan or renew it — will turn on the prospect of profit from the sale of the second finance bill, and this will depend on the same set of conditions which called forth the original lending operation. If the discount rate in London is still sufficiently lower than in New York, and the two bankers are satisfied that the sterling sight rate is not about to rise, the loan may be extended. However, if the London discount rate has risen in the meantime so far as to remove all prospect of continued profit from the loan, the loan will be closed out, causing a net increase in the demand for sterling sight in the New York market.

There is still another effect to be considered. When the London discount rate rises sufficiently, the lending operation just discussed will be reversed, and foreign bankers will be induced to lay out funds in short-term investments on the London market. In the past, when loan funds have flowed from New York toward London, the method employed by the bankers has not been the exact reverse of that employed when London was lending. Finance bills have not been drawn by London bankers on New York correspondents, but the latter have bought sterling demand drafts or cable transfers and forwarded them to London for encashment. The reason for this difference lay in the fact that bankers' acceptances were prohibited by the laws of the United States and there existed no open discount market in New York. These obstacles have been removed since the passage of the Federal Reserve Act in 1913, but the new system has not as yet been tried out under normal conditions.¹ Before the Great War, therefore, when conditions were such as to encourage the lending of funds in the London market by foreign bankers, an increase in the demand for sterling sight drafts has been the result. This factor, tending to restrain the decline of the sterling sight rate, has not been so potent in New York as have the others which we have considered, since the London discount rate has rarely risen above that of New York. But

¹ The conditions operative in the New York market both before and after the passage of the Federal Reserve Act are discussed in Chapter XIV.

it has been *possible* for the Bank of England to carry its policy of raising the discount rate so far that such loans would become profitable, and this result has sometimes occurred especially with regard to other European centers.

Through these channels the Bank of England has been able to exert an influence over the conditions of demand and supply for sterling exchange in foreign markets. It is customary to summarize the effect of the Bank's policy somewhat as follows: the raising of the discount rate in London discourages the outflow of loan funds from that city and encourages the inflow of loan funds from foreign financial centers. This statement is misleading in that it calls before the mind the picture of foreign bankers arbitrarily shipping gold to London, or ceasing to ship gold out of London, in order to make loans at the high rates of interest which prevailed there; whereas the policy of the Bank of England has had the particular merit of working with the natural forces which determine the rates of exchange in markets outside of England. In spite of this objection, however, the statement is essentially correct. In each of the transactions we have discussed there has been involved a decision on the part of foreign bankers either to cease to borrow on the London market or to lend on that market. The purchase of sterling long bills for investment instead of for discount, the discontinuance of the practice of drawing sterling finance bills, the closing out of loans already contracted, all indicate a decision by foreign bankers to withdraw from the London discount market as borrowers; the remittance of demand sterling to London bankers for the purpose of making loans in London brings foreign bankers into the discount market of that city as lenders. The bankers concerned with these credit operations need have nothing to do with the transportation of gold to and from London; but their action has an effect upon the sterling sight rate which reacts upon the profits of all bankers engaged in shipping gold, and controls their operations. It is not to be assumed that the Bank of England has had power to resist the operation of strong basic forces — such as a long-continued unfavorable balance of trade — which determine the larger movements of the rates

of exchange; during short-run periods, however, its policy of adjusting the rediscount rate has had a decisive influence over the movements of gold.

81. Other expedients for controlling the movement of gold. Aside from absolute surrender of specie payment, there is no method of restraining an outflow of gold equal in effectiveness to the method considered in the preceding section. The expedient of raising the discount rate in the open market is unique in that it works upon the *cause* of the gold movement by sustaining the rates of sterling exchange in the banking centers of the world, and it does this by coöperating with the basic forces of demand and supply. The raising of the discount rate is not, however, the only resource of the Bank of England when desirous of preventing an outflow of gold from London. Another device is sometimes employed, aimed, not to restrain the sterling sight rate from falling to the specie importing point in other markets, but to lower the specie point, itself, so that a further fall of the sight rate may occur without producing an outflow of gold from London.

It will be recalled that the specie importing point on sterling exchange in New York is determined by the costs of transporting gold from London to New York; if these costs amount to two cents on the pound, the specie importing point will be 4.8465; if they amount to four cents on the pound, the specie point will be 4.8265. Most of these costs consist of actual shipping charges — cooperage, freight, cartage, insurance, interest; but before the total expense incurred by importing gold can be determined, the importer in New York must turn the gold into dollars and discover what amount of American money he has in hand as the result of the transaction. Any influence which reduces the number of dollars resulting from the transfer of a sterling credit from London to New York by gold importation must be considered one of the shipping costs and will have its effect in determining the specie point.

Gold is obtained for exportation from London by presenting bank notes to the Bank of England for redemption in gold sovereigns; the Bank is not obliged to redeem these notes in other kinds of gold — bars, or foreign gold coins — though

it usually has a supply of these in stock. If the American importer obtains his gold in the form of sovereigns, these will be paid over to him by *count*: one gold sovereign for each paper pound; but he must turn these English gold pieces into dollars on the basis of *weight*: 23.22 grains of fine gold for each dollar. Accordingly, the returns from his transaction when it is completed will be much affected by the weight of the gold pieces obtained from the Bank of England. Now, all coins lose weight while in circulation, and the mint laws of all nations take this inevitable loss into account by establishing what is called a "limit of tolerance," which states how light a standard coin of the monetary system may become before it loses its legal tender quality. In England, a gold sovereign may suffer a loss of weight of approximately six tenths of one per cent before it is withdrawn from circulation; sovereigns, light in weight, provided they fall within this limit of tolerance, may be paid out by the Bank of England in discharge of its obligations to redeem bank notes on demand. When, therefore, the Bank wishes to restrain an outflow of gold, it may pay out these light-weight coins, solely; this policy will increase the expense of the foreign banker on whose account the gold is withdrawn by giving the gold a lower value when turned into his national currency on the basis of weight. It will, therefore, lower the specie importing point on sterling exchange, since the new cost must be taken into account in determining the quotation on sterling sight drafts at which it becomes more profitable to import gold than to sell checks on London.

When, on the other hand, the importer of gold asks for bar gold or American eagles at the Bank of England, these will be sold him by *weight*; since the Bank is not bound to redeem its notes in these forms of money, it will be free to set its own price upon the gold. The gold bars or the American coin will be considered a commodity whose price is subject to bargain between buyer and seller. As a matter of practice, the Bank of England does not raise its selling price for gold in this form above a certain rather rigid limit; for the buyer has always the alternative of demanding gold sovereigns which,

at the very extreme, cannot be more than six tenths of one per cent light in weight, and he will adopt this alternative if the Bank's selling price for bullion is too high. But some variation in the Bank's selling price there is, and by raising this price when it wishes to restrain an outflow of gold, the Bank can add to the costs of the gold shipment and lower the specie importing point in foreign markets, correspondingly. These devices, it must be repeated, do nothing to prevent the decline of the sterling sight rate and so do not affect the fundamental cause of the gold movement; but when the forces which are depressing the rate of exchange are not too powerful, the expedient of removing the specie importing point to a lower quotation may suffice to forestall an outflow of gold from London until a change in the conditions of demand and supply for sterling sight drafts abroad puts a stop to the decline of the rate.

By methods correlative to these, the Bank of England may *lower the specie exporting point* in other markets on sterling exchange, and induce a flow of gold into London sooner than it might otherwise occur. The specie exporting point is determined by the costs of shipping gold to London; the Bank can reduce these costs by affecting two of the elements of which they are composed: the interest charge, and the value of the gold in English money upon its arrival in London. Normally, interest is lost while gold is in transit, but when it is considered especially desirable to encourage the importation of gold into London, the Bank of England adopts the policy of allowing the importer an interest-free loan equal to the value of the shipment while the gold is in the hands of the transportation company. This removes one of the costs of gold importation. Again, the Bank may raise slightly its buying price for the gold, thus making it possible for the importer to create a sterling credit somewhat greater than the intrinsic value of his shipment by depositing the gold with the Bank of England. These expedients, by making it less expensive to foreign bankers to ship gold to London, have the effect of lowering the specie exporting point on sterling exchange in markets outside of England, and thus making it correspondingly easier for

the sterling sight rate to rise to the exporting point. Here, again, the Bank's policy will have no influence upon the rate of exchange itself; but when the rate is rising as an effect of other forces, this policy of the Bank may place it at the specie exporting point by lowering the latter. However, no great reliance is placed in these more arbitrary methods of regulating the flow of gold, since the power of the Bank to work through its control over the rates of discount in the open market is more effective and far-reaching.

Though we are not at present concerned with the operation of exchange markets other than London, it may be useful, by way of throwing into clearer light the peculiar power of the Bank of England, to summarize briefly the method employed in other financial centers to control the ebb and flow of the gold stock. No other city has enjoyed power in this regard commensurate with that of London. Relying upon this power to protect herself against a sudden drain of gold, England has been able to maintain a gold standard, with vast outstanding liabilities payable on demand, upon the basis of a very slender gold reserve. Analysis of the preceding discussion shows that the secret of this defensive power of England has consisted in two essentials; in the first place, the fact that bankers all over the world were constantly in contact with the discount market of London because of their immense dealings in sterling long bills; and, also, the fact that the terms upon which these bills could be discounted were, in times of stress, under the conscious and centralized control of the Bank of England. By dictating the prices for this stream of sterling long bills in London, the Bank could alter the conditions of demand and supply for sterling sight drafts in all the principal foreign markets and so affect the behavior of the sterling sight rates all over the world. In no other financial center have these two conditions of effective control over the movement of gold existed simultaneously.

New York, for example, has lacked both of these essential conditions until very recent years, for there has been neither a central control over the interest rates, nor a stream of dollar long bills inflowing from foreign markets. In Berlin and Paris,

where the discount rates are subject to qualified control by the Reichsbank and the Bank of France, respectively, the supply of acceptances has been too insignificant to affect the conditions in the exchange markets of other countries. New York has, therefore, had no protection against an outflow of gold except some quite arbitrary interference with the natural currents between the financial centers of the world. This condition has obtained until the present, though there is reason to believe that, with a restoration of normal credit conditions, our new banking machinery will give New York a power over the gold movements somewhat similar to that enjoyed by London.

Berlin has made use of the expedient of raising the discount rate to protect her gold reserve, but has been forced to rely in the main upon supporting policies which were less automatic and more arbitrary. The Reichsbank had adopted the policy of carrying among its assets large holdings of acceptances payable in gold standard countries (principally England) which it was at liberty to return for sale to the market on which they were drawn. These acceptances have been used as a sort of protective barrier for the gold reserves of the Reichsbank; to stop an outflow of gold, arising from the fact that the mark sight rate had fallen to specie importing point in other markets, the Reichsbank would return these acceptances to the market where they were payable, discount them, and use the proceeds to buy up mark sight exchange. This action would retard the decline of the mark sight rate. When it was desired arbitrarily to bring gold to Berlin, the proceeds derived from discounting the acceptances would be collected in gold from the central bank of the market and shipped in that form to Germany. So long as the gold standard was maintained in the country where the acceptances were payable, their possession by the Reichsbank constituted a claim for an equivalent amount of gold, which claim could be pressed at any time. These devices, though effective over short-run periods, have had at best but a temporary influence; once employed, their effectiveness was at an end, and they could exert no continuing influence as does the manipulation of the discount rate by the Bank of England.

France is not committed to an unqualified gold standard as is Germany and England. In her monetary system — the “limping standard” similar to that of the United States — both gold and silver coins possess legal tender power; nor are the silver five-franc pieces convertible into gold, for in France a condition obtains very like that of the United States where the silver dollar is redeemable in gold only at the option of the banks. Accordingly, the Bank of France has had a very effective method of protecting its gold reserves in times of stress; it merely exercised its legal right to redeem notes in silver when gold was being withdrawn in large quantities for export. Thus estopped from obtaining gold from the central bank, the exchange dealers have been compelled to buy it as a commodity in the form of bars or foreign coins; and, since the Bank of France has been the principal holder of gold in this form, they have been compelled to accede to the Bank’s terms of sale. This has given into the hands of the Bank the power to increase the costs of importing gold from Paris into other markets, and thus to lower the specie point on franc exchange. Paris has never acquired the reputation of a free gold market; holders of franc bills have not been assured of their ability at all times to convert their bills into their nominal gold equivalent; and, therefore, the specie point on franc exchange has been open to fluctuations in harmony with the policy of the Bank of France. Relying upon this power to control gold movements, the Bank of France has rarely had recourse to the expedient of raising the discount rate; but the policy has done something to prejudice the standing of Paris as a center of international finance, and to prevent her from acquiring the unquestioned credit standing enjoyed by London.

82. The bases of London’s supremacy. The proof of the dominance of London among the exchange markets of the world has been the use of the sterling long bill as the standard financing instrument in *non-British* trade. Bills drawn in the other European currencies and in dollars have been, in the main, restricted to the trade to which the countries using these moneys were party; sterling bills, alone, have been

largely employed in the trade of the world in general. Long bills drawn on London bankers have streamed into the discount market of London from all the trading centers of the world, there to be absorbed at low rates of discount by the brokers and money-lenders of the open market; their maturity in continuous sequence has called for the remittance to London of a corresponding volume of sterling sight drafts drawn by foreign bankers upon their London balances for the benefit of business men everywhere who were under obligation to make payment for goods imported, or services enjoyed, in international commerce. Thus, in the decades preceding the Great War, London held without question the position of the greatest clearing house for the world's commercial credits. Since the war, however, there has been a tendency among American students and writers to call into question this position of London, and to express the belief that New York will soon supplant her as a center of foreign exchange. To throw some light upon this problem and to prepare the ground for our discussion of the New York market in the chapter which follows, we shall undertake now to summarize the bases upon which the position of London has rested in the past.

Any inquiry into the causes of London's supremacy must begin with a consideration of the question why business men in the world's trading centers have preferred to employ sterling long bills rather than bills drawn in other moneys. At the outset of this inquiry, it must be understood that the nature of the bill of exchange which arises from a given transaction in foreign trade is but one of the many details covered by the terms of sale; and that the decision of the two parties is made upon the basis of superior convenience and economy. If the sterling long bill has been more widely employed than have bills of other kinds, it is because this type of exchange has possessed such superiorities as a financing instrument that its use would increase the profits, or reduce the costs, of the traders. Examining the matter from the point of view of the exporter, the reason for this preference for sterling is not far to seek: this type of exchange could be sold to bankers with a minimum of difficulty and at rates which were both relatively

low and stable as compared with rates for other kinds of bills. Possessed of a sterling London bill drawn upon a London banker, the exporter's financing costs and risks of exchange were reduced to a minimum, and this fact reacted, not only to the larger profit of the exporter, but also to the benefit of the importer in the form of lower prices or better credit terms. Thus, self-interest, the final authority in matters of business, has encouraged the use of sterling exchange.

However, it becomes apparent upon reflection that these characteristics of the sterling long bill which have commended it to the business men — namely, marketability and favorable and stable rates of exchange — are qualities bestowed upon sterling exchange by the bankers who create a market for the credit instruments of the exporter. The ease with which sterling long bills could be sold in all quarters of the world has been, of course, but a reflection of the willingness of bankers to acquire credits in London; the favorable buying prices, and the stability of the sterling rates, have been due to the broad, competitive market created by the buying bankers, and to the fact that minimum rates of discount were used to compute the buying rates for sterling exchange. When, therefore, we say that the preference of business men for sterling exchange has been due to the superior economy of these bills, we but restate our problem in another form. It remains to inquire why the bankers who deal in foreign exchange have accorded especially favorable treatment to bills drawn on London.

The willingness of bankers to buy bills drawn on any financial center is governed by the demand in their markets for the checks which they draw against the credit created by these bills. Long bills payable in out-of-the-way places will not be bought by the bankers at all, but will be handled for collection only; of all kinds of exchange, the bankers will show the least hesitancy in buying those drawn upon a city where it is profitable to maintain a credit — profitable, because the bankers' clients are continually in need of sight drafts payable out of that credit. As for the discount rates employed by the bankers in determining their buying prices for long bills,

these, as we know, are taken from the published rates of the market in which the acceptances will be sold; that is to say, the buying prices for sterling long bills are determined by the discount rates of London, those of dollar long bills by the discount rates of New York, etc. Here, then, are two basic factors which have promoted the use of sterling long bills in foreign trade: (a) the great demand in all quarters of the world for sterling sight drafts; (b) the low discount rates and the tremendous absorbing power of the London market. We shall now examine these factors briefly.

The widespread demand for bankers' sterling sight drafts has been of complex origin. Obviously, we have here an interaction of cause and effect, for the very fact that sterling long bills have been widely used as financing instruments has, of itself, resulted in a broad and widely diffused demand for sterling sight drafts. Importers who establish London credits in favor of exporters are obliged to make a deferred remittance of sight drafts to meet the exporter's bill at maturity. Demand for sterling sight drafts arising from this source, however, will not of necessity appear in the same market where exporters are offering sterling long bills for sale in large numbers. For example, if importations of raw silk from Japan to America are financed by sterling letters of credit, a supply of sterling long bills will appear in Japan and a demand for sterling sight in America at a later date. This particular demand for sterling sight drafts will not avail to employ the London credits of Japanese bankers who buy the sterling long bills. To effect a substantial equilibrium of demand and supply for sterling exchange in Japan through the use of letters of credit, Japanese importers must employ these letters to the same extent, approximately, as do Japanese exporters. It is conceivable that, in some markets, the sterling credit is used by these two sets of business men in roughly equivalent amounts, so that the use of sterling exchange *as a financing agency alone* clears the accounts of the bankers; but this cannot be true generally. The widespread and stable demand for sterling sight drafts which keeps the London balances of foreign bankers employed arises from other sources and is created by other economic factors.

England was the first among modern nations to develop a foreign commerce with widely scattered world markets. For hundreds of years, her goods have been sold to foreign peoples. To her own export trade is to be attributed a share in the creation of that vast amount of current indebtedness of foreign countries which has resulted in a seasonal demand for sterling sight drafts. Again, England early became a creditor nation and is to-day the greatest of creditor nations. Her investments in Asia, Africa, Australasia, the Far East, and North and South America had, according to the best estimates, reached in 1914 the tremendous total of twenty-one billions of dollars and were increasing at the rate of a billion a year. These investments have brought continuous accruals of interest and principal in vast amounts and at widely separated points, which, in turn, have created a continuous and diffused demand for sterling exchange. England's merchant marine carries the freight of other nations to an extent not equaled by any competitor, and the consequent payment of freight charges to English shipowners has contributed to the demand for sterling exchange in foreign markets. These economic foundations have been built up by long years of endeavor and, though shaken by the terrible strain of the Great War, they remain to-day virtually intact. The demand for bankers' bills on London rests upon these firm foundations; variable and independent as these economic forces are, they serve to compensate one another, stabilizing the bankers' market for sterling exchange and protecting it against the discontinuous and erratic movements which would otherwise result from the ebb and flow of international commerce. As a consequence, the balance maintained in London by foreign bankers has shown a high rate of turnover; to repair this balance, the bankers have been ready to buy sterling long bills at all times.

Let us now inquire into the causes of the low discount rates which have been employed by buying bankers when computing their prices for sterling long bills. Other things equal, the exporter will choose as a financing instrument that kind of exchange which will sell for the highest price in his own

money; or, to state it in other terms, that kind of exchange which will command the lowest rate of discount when sold after acceptance. Assume, for example, that in some foreign market, such as Hongkong, the dollar and the sterling sight rates are both at par, but that in London the discount rate for prime bankers' acceptances is three per cent while in New York the rate for the same class of bills is five per cent. Under these conditions, the exporter in Hongkong, even if he can sell both kinds of exchange with equal ease, will prefer to finance his sale in sterling, since by so doing he can save two per cent of the face of the bill in financing costs. This preference for sterling will lead him to quote better terms to those buyers who agree to provide a sterling credit than to those who instruct him to draw in dollars. If this buyer is an American importer, self-interest will induce him to make payment in sterling rather than in dollars, and, contrary to common opinion, this patronage of London banks in preference to those of his own country will react to the benefit of himself and his market, in the same manner that any saving of costs results in gain. The establishment of American branch banks in Hongkong will not suffice to overcome this preference for sterling exchange so long as the discount rate of London remains appreciably below that of New York. In the past, London has underbid other financial centers with respect to the rates of discount; while this remains true, there is little likelihood that sterling will lose its position of dominance in the exchange markets of the world.

The low discount rates of London have been due partly to the vast supply of loan funds which seek investment there; partly, also, to the mechanism of the market which has turned these funds into the market for bills of exchange rather than in the direction of other kinds of short-term investment. The same forces which early placed England in the lead as a lending nation made of the London money market a vast reservoir of liquid capital seeking employment for short terms. The industrial development of England began earlier than that of other nations, and this early exploitation of investment opportunities within the country at once accelerated the

pace of capital accumulation and forced investors to look abroad for profitable employment for their savings. As the supply of capital increased, it flowed in increasing volume to the financial center of the country, there to seek investment at rates of interest which, under the stress of competition among the lenders, fell to very low points. At the same time, the mechanism of the money market developed along lines which encouraged the use of this vast supply of loan funds in the purchase of bankers' acceptances, and thus brought the low discount rates to bear upon sterling long bills bought and sold in foreign markets. Bankers and acceptance houses adopted early the practice of making acceptances for the account of their clients, thus resolving the trade bill into a credit instrument of the very best quality, affording the security demanded by the investor of liquid capital. Bill brokers and discount houses multiplied, widening the market for these acceptances and narrowing the range of fluctuation in the rates of discount. The Bank of England, first and greatest of modern central banks, afforded the rediscount opportunity necessary to stabilize the market, to prevent sudden tightening of credit, and to increase the confidence of the smaller money-lenders. Of utmost importance in its effect upon the market for bills of exchange was the practice of the great commercial banks of the city in choosing to carry their liquid reserves in the form of discounted acceptances. In New York, these reserves are invested, to a large extent, in call loans secured by collateral of stocks and bonds, and thus are absorbed in the speculative activities of the Stock Exchange. But in London, the practice of fortnightly settlement by the Stock Exchange prevented this employment of the liquid reserves of the banks; bankers' acceptances afforded the safest and most readily convertible means of equalizing the cash position of the commercial banks, and, accordingly, these large reservoirs of loan funds have found their outlet in the open market for bills of exchange. The final result of these developments has been to reduce the financing costs of foreign merchants who have employed the sterling long bill as a financing agency.

This summary of the forces which have perfected the discount market of London would be incomplete without some reference to the gold standard policy of England. Gold, more than any other metal, possesses international purchasing power; bankers are encouraged to maintain balances in foreign money centers when they have confidence in their ability to convert these credits into gold at all times. London, before the Great War, was the only city in the world whose record of discharging her obligations in gold without question was of long enough standing to have inspired in foreign bankers an implicit confidence in the validity of her credit. This reputation of London as the only "free" gold market has had its part to play in accounting for the supremacy of sterling exchange.¹

¹ The statements made in this chapter concerning the movement of gold between the nations refer, of course, to normal conditions. At the time of writing (1921) the gold standard has broken down almost universally. We cannot base our discussion of the laws which control the exchange markets upon abnormal and temporary conditions, however.

CHAPTER XIV

THE NEW YORK MARKET

83. Former position of the New York market. The rise of New York to prominence among the exchange markets of the world has been a matter of very recent development, dating from the outbreak of the Great War. Prior to 1914, New York's position was in no wise comparable to the position of London. The financing of our trade fell largely into the hands of London banks; letters of credit, when issued by our bankers, were usually sterling letters; sterling long bills and demand drafts were employed in large volume by our traders to perform the collection and financing services, and to make the remittances, required in our commerce with foreign markets. Since 1914, however, due partly to changes in our banking laws and to internal developments which were the consequence of these changes, and partly to the effects of the war which broke up the settled channels of commerce and impaired the operation of the London exchange market, the progress of New York has been very rapid. It will help us toward an understanding of the present mechanism of the New York market to examine briefly the conditions which obtained prior to these recent developments.

The inadequacy of the mechanism of the New York exchange market to meet the needs of a financial center in international commerce will become apparent when we review the handicaps under which that market labored before the passage of the Federal Reserve Act in 1913. In the first place, bankers' acceptances were virtually unknown; the practice of making acceptances was prohibited to bankers of the national banking system by federal law, and a similar prohibition in the state laws prohibited the practice to other bankers. This handicap was of itself sufficient to prevent the use of dollar letters of credit both by our own merchants and by those of other countries, since the letter of credit is an instrument

devised for the particular purpose of utilizing the banker's acceptance. When foreign exporters drew long bills in dollars, these bills were drawn almost entirely upon business men, and, hence, became trade acceptances difficult to market with the drawer's bank and subject to widely fluctuating rates of exchange.

Closely related to the absence of bankers' acceptances was a second great weakness: the lack of an open market for bills of exchange. The banker's acceptance is an instrument well adapted to the needs of the discount market; it is always clean after acceptance, thus being readily transferred by endorsement and having a fixed maturity; its credit standing is of the highest; it can be resold without difficulty, and, hence, is an extremely liquid investment instrument. Trade acceptances, which are usually documented until payment, subject to the option of prepayment by the acceptor, and which acquire their credit rating from the name of a business man, are never bought and sold with the ease and at the low and stable rates accorded the acceptances of banking houses. This is not to say that the absence of a discount market in New York is to be attributed solely to the fact that dollar bankers' acceptances were unknown; for other causes contributed to this result. The fact itself, however, is evident without question; the money-lenders of New York employed their liquid funds in investments other than accepted bills of exchange. The banks relied principally upon collateral-secured call loans to brokers and traders on the Stock Exchange to equalize their cash position and liquefy their assets; and the money brokers and other middlemen were engaged chiefly in handling the short-term promissory notes of the commercial world. The accepted bill of exchange of short maturity, which supplied by far the most important material of the London discount market, held an insignificant place among the investment instruments of New York.

Before proceeding to discuss other shortcomings of the New York market, it may be well to consider how the inability of American bankers to make acceptances, and the absence of an active discount market, reacted upon the exchange trans-

actions of American traders. It was pointed out above that the former of these handicaps compelled our importers to employ sterling letters of credit whenever that method of financing foreign trade was adopted. The fact that foreign bankers had no assurance of their ability to discount dollar acceptances in New York made the marketing of all long dollar bills in foreign markets very difficult. Bankers buy long commercial bills primarily as cover for their demand drafts, intending to discount the bills upon arrival and to carry the proceeds of the discount to the credit of their foreign balances. When unable to discount such a bill, the banker who buys it must resign himself to making an investment of the funds he advances until the investment is liquidated by the drawee's payment at maturity. But dealers in exchange engage only incidentally in these investment operations, and the amount of business of the kind which they can do on a given capital is strictly limited; in the majority of cases, they act only as middlemen, taking for collection such bills as they are unable to discount. Because of the absence of a discount market in New York, therefore, a very narrow demand existed among foreign bankers for long bills drawn in dollars, and this narrow demand threw the dollar rates open to wide fluctuations and subjected the drawer to considerable risk of exchange whenever he was able to market his bill at all. In many markets, in fact, dollar rates were never quoted, the supply and demand for these bills being so narrow as scarcely to constitute a market. When unable to sell his long dollar bills, the drawer was, of course, compelled to wait for his money until collection had been effected, which resolved his sale of goods to American buyers, when financed by long-term dollar bills, into a credit transaction of considerable length. For these reasons, exporters in foreign markets were loath to accept terms of sale which called for the drawing of bills in dollars.

This appears to be an appropriate point at which to touch upon the question of "direct exchange," concerning which there has been so much discussion among writers on foreign trade financing. The expression refers to the practice of financing foreign trade by bills of exchange drawn by the

exporting market on the importing market in the money of the importing market; or, to state it otherwise, the making of payments directly between the two markets without the intermediation of a third center. In our import trade, direct exchange would require the drawing of bills by the foreign seller in dollars; in our export trade, the drawing of bills by the American exporter in the money of the importer — pounds, francs, pesos; and in both branches of trade the negotiation of these bills by the bankers of the two markets without help from the outside. This practice appears desirable to many people because it throws the negotiation of the bills into the hands of American banks who retain the profits from the service. The American merchant is supposed to be benefited by the practice through some virtue which inheres in his patronage of a fellow countryman. Without at present raising the question of the merits of direct exchange, we are prepared to understand why the practice has not been common in the import trade of the United States in the past.

For reasons stated in the preceding paragraph, the foreign merchant has rarely agreed to draw upon his American customer in dollars; either he did not draw at all — requiring a remittance from the importer — or he requested authority to draw in sterling on London. Moreover, when remittances were made from this side, dollar demand drafts were not frequently employed. In our import trade with Europe, remittances frequently took the form of demand drafts upon banks in the exporter's country, since our bankers maintained active balances in most of the important European centers and were prepared to sell drafts against these balances. Outside of Europe, importers usually discharged their obligations to make remittances by sending sterling demand drafts. This for a double reason: American bankers were prepared to draw these drafts in large volumes, whereas they were not similarly prepared with respect to most non-European markets; and the bankers of our foreign creditors have always been willing to cash sterling demand drafts because of the ease with which they found opportunity to draw against their London balances. In general, therefore, our trade has not been financed

by direct exchange. The weakness of the New York discount market was chiefly responsible for this condition of affairs.

A third weakness of the mechanism of the New York market prior to the passage of the Federal Reserve Act was the absence of any central agency of rediscount: there was no institution in New York similar in purpose and function to the Bank of England, the Bank of France, or the Reichsbank of Berlin. The services of such an institution to the money market have been described in other places with the Bank of England serving as a type,¹ and need only be summarized here. A central agency of rediscount increases the readiness of bankers to buy acceptances for investment by affording them opportunity to liquidate their assets on short notice; it is able, under favorable conditions, to regulate the open market rates of discount, to attract credit from foreign centers, and to determine, within broad limits, the amount of business done in the market; it can exert some control over the ebb and flow of the gold stock through its power to regulate the rates of discount. The New York market lacked these services; and this gap in its mechanism was, to some extent, the cause of the arrested development of an open discount market.

In any discount market, the loan funds employed are drawn principally from the current cash balances of banking establishments, balances which must be invested for short terms in highly liquid credit instruments. In London, the acceptance has long been the premier instrument for this type of investment because of its short term, its security, and the ever-present opportunity of the bankers to find relief from an over-extended position by rediscounting with the Bank of England through the medium of the exchange brokers. Consequently, the London banks have devoted large amounts to investment in acceptances, either by direct purchase of the acceptances for their own accounts, or through call loans extended to the brokers on the collateral security of acceptances. In New York, on the other hand, the inability to rediscount has impaired the liquidity of acceptances and rendered them in-

¹ See pages 334 f.

eligible to serve as investments for the cash balances of the banks, debarring them for the same reason from serving as collateral for the call loans of brokers. The investment by the banks of their current balances in call loans secured by stocks and bonds — a type of investment made eligible for this purpose by reason of the instant marketability of the collateral — turned the current loan funds of the market toward employment either in the speculative activities of the stock market, or in the provision of fixed capital for the large corporations.

Two other impediments to the development of the New York market should be considered; namely, the absence of foreign branches of the New York banks and the restrictions placed by law upon the operation of the New York branches of foreign banks. Before the reform of our national banking laws in 1913, national banks were forbidden to establish branches at home or abroad. The state banks had, it is true, begun to establish foreign branches during the years immediately preceding this date, and a few of the larger private banking houses had opened branches in the principal European centers; but the development of these foreign connections was, on the whole, insignificant. The branch establishments of foreign banks in New York were hampered by state laws prohibiting the acceptance of deposits and otherwise restricting their operations; both of these conditions operated to prevent a close union of New York with other money centers. In contrast with this situation, the growth of foreign branch banking in other countries was striking. Before the Great War, forty English banks operated 1325 branches in foreign countries; five German banks maintained forty branches in South America alone, and in the same continent, five English banks had seventy branches.

Now, it is possible to overestimate the importance of American branch banks in foreign markets. Correspondent relations with native banks afford a method of handling foreign exchange which may be as inexpensive and efficient as that afforded by the establishment of foreign departments by our banking houses. It has been urged in favor of the latter method,

that the reliance of our traders upon foreign institutions for the collection of accounts, and the handling of the bills of lading and other documents which accompany the commercial bill of exchange, has subjected them to the betrayal of trade secrets to foreign competitors. Investigation has failed to bring to light evidence that this risk was ever operative to a significant degree. But in certain respects it *is* to the advantage of business men to conduct their exchange transactions through their own banks entirely. This method assures a continuity of responsibility on the part of the home banker which reduces the client's risk of loss due to violation of instructions or mistaken judgment by the foreign agent. Furthermore, collecting foreign bills through the branch offices of a home bank in many cases affords better protection to the merchandise shipped in connection with a documentary bill. Some countries — notably in South America — are lax in requiring the consignee to present a bill of lading in order to obtain goods from the customs house, and this practice materially reduces the value of the bill of lading as security for a payment draft. Dealing through American branches, in such cases, assures the drawer of the bill, client of the home office, more rigid defense of his rights. It is also probable that in the storing of merchandise and its release on trust to the buyer, the interests of the shipper will be more carefully conserved when he is a client of the home office, of which the local bank is a branch. Finally, and most important, the spread of branch banks opens up sources of credit and trade information to the American merchant which makes possible a more intelligent handling of his credit risks.

The competing power of an exporter in the world markets is to some extent conditioned on his willingness to offer attractive credit terms and convenient and inexpensive methods of financing the sale. From the standpoint of the foreign buyer, the exercise of choice between competing goods of like quality will turn upon the question of cost — including the interest charge involved in financing his purchase — and the length of time accorded him within which to make payment. The readiness of the average exporter to extend

credit to his foreign customer depends primarily upon two factors: access to reliable and comprehensive sources of credit information covering foreign markets; and the existence of machinery through which to dispose of his long bills and thus release himself from the immediate burden of carrying the risk. The cost of extending the credit — that cost which the exporter must add to the sale price of his goods — is comprised, not principally of bankers' commissions, but of the discount which is applied to his bill when bought by the banker, and this is determined by the efficiency of the discount market in which the banker disposes of the bill after acceptance. The establishment of foreign branches by American banks, by opening up sources of credit information and acquainting the exporters with methods of financing foreign sale, will enable American sellers to offer more liberal credit terms, and, hence, will increase their competing power to some extent. But this development, of itself, will not suffice to reduce the financing costs of American exporters — and the sale prices of American goods — to an equality with those of all other competitors. The spread of foreign branches must be supplemented by the development of a discount market as efficient and inexpensive as those of other countries before the credit costs of American merchants, who conduct their transactions through American banks, can be placed on a par with those of his competitors in other countries.

84. The Federal Reserve Act and its relation to the exchange market. We are concerned with the banking structure of the United States only in so far as it is related to the business of foreign exchange and the development of the exchange market in the United States. Accordingly, we shall deal with the Federal Reserve Act solely from the point of view of its bearing on this particular subject. The Act was passed for the purpose of remedying certain obvious and long-standing defects in our banking mechanism; with regard to foreign exchange, the most serious of these defects, to recapitulate the substance of the preceding section, were the following:

- (1) The inability of American banks to make acceptances.

- (2) The absence of an open discount market in which acceptances could be bought and sold.
- (3) The total lack of a central agency of rediscount.
- (4) The absence of foreign branches of American banks.

By the terms of the Federal Reserve Act, any bank, member of the Federal Reserve System, is now empowered to "accept drafts or bills of exchange drawn upon it having not more than six months' sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving domestic shipment of goods,¹ provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such documents conveying or securing title covering readily marketable staples." The law also permits any member bank to accept "drafts or bills of exchange drawn upon it having not more than three months' sight to run, exclusive of days of grace, drawn under regulations prescribed by the Federal Reserve Board by banks or bankers in other countries for the purpose of furnishing dollar exchange as required by the usages of trade in the respective countries."²

The number of acceptances which a member bank may make is limited by the Act as follows: Of commercial bills, no bank may accept for any *one* drawer an amount exceeding at any time ten per cent of the bank's capital and surplus, unless the bank is secured by attached documents or by some other security growing out of the same transaction as the acceptance. Even when thus secured, the bank may not accept these bills for any one drawer to an amount exceeding one half of its capital and surplus. This limitation, however, may be relaxed at the pleasure of the Federal Reserve Board to permit a bank to accept for one drawer to an amount equal to its capital and surplus, under regulations prescribed by the Board. Of bankers' bills, the number of acceptances made for

¹ The power to make acceptances was originally restricted to foreign bills, but was extended to domestic bills by the amendment of September 7, 1916.

² Amendment to the Act, 1916.

any one drawer is similarly limited to ten per cent of the bank's capital and surplus if the bill is unsecured, and to fifty per cent if the bill is secured by documents conveying or securing title, or by some other security. In this case, the Board has no power to relax the restriction. Coincident with this new power of the national banks to make acceptances, the state laws in New York and other states were revised to permit state banks and trust companies similar power.

These new powers conferred upon our banks adequately cover the needs of the merchants of the United States for the banker's acceptance as a financing instrument. Dollar letters of credit are now issued on behalf of importers, and the drawing of long-term dollar bills by foreign sellers — a development stimulated by the abnormal conditions created by the Great War — has rapidly increased. The authority of our banks to accept commercial bills has also been adapted to the needs of our exporters. One way in which this is done is as follows: the exporter assigns to the bank his claim against the foreign buyer and binds himself to place the bank in funds before the maturity of the acceptance; he is then permitted to draw against the bank for the value of his goods and to liquidate the sale by discounting the acceptance in the open market. Another method places upon the foreign buyer the duty of taking the initiative in providing means for financing the sale; the buyer, through the medium of his bank, establishes a dollar credit in favor of the exporter, who draws against an American bank for the value of his goods and obtains his money by selling the acceptance. In these transactions, the accepting bank, of course, merely lends its credit; the funds with which the transactions are financed are drawn from the discount market when the acceptance is sold, and it is upon the adequacy of these funds to absorb the acceptances made by our banks that the efficiency of the dollar banker's acceptance as a financing instrument in foreign trade is conditioned.

It should be apparent that the absence of a discount market for acceptances could not be entirely corrected by legislation. The law can create conditions favorable to the devel-

opment of such a market by removing obstacles which formerly hindered its growth, but the practice of investing current funds in acceptances in preference to their investment in short-term instruments of other kinds must be left to the initiative of the money-lenders acting under the spur of self-interest. We shall postpone our discussion of the development of the discount market in New York to the following section, proceeding at this point to examine other features of the Federal Reserve Act which have operated to favor the growth of the discount market.

The third of our list of obstacles to the development of New York as a world center of foreign exchange has been removed: the law has created machinery for rediscounting the assets of the banks. Twelve institutions have been established for this purpose, each serving directly the needs of its prescribed district,¹ the entire system being drawn together through powers granted each Reserve Bank to take over the assets of another under regulations laid down by the Federal Reserve Board. Not all kinds of commercial paper are eligible for rediscount by the Federal Reserve Banks. The language of the law covering this point is as follows:

Upon endorsement of any of its member banks, which shall be deemed waiver of demand, notice, and protest by such bank as to its own endorsement exclusively, any Federal Reserve Bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus made eligible for

¹ These institutions are called the Federal Reserve Banks. They are located throughout the country as follows:

<i>District</i>	<i>City</i>	<i>District</i>	<i>City</i>
1	Boston	7	Chicago
2	New York	8	St. Louis
3	Philadelphia	9	Minneapolis
4	Cleveland	10	Kansas City
5	Richmond	11	Dallas
6	Atlanta	12	San Francisco

discount, within the meaning of this Act. Nothing in this act contained shall be construed to prohibit such notes, drafts, and bills of exchange secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the United States Government. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety days, exclusive of days of grace; Provided, that notes, drafts, and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months, exclusive of days of grace, may be discounted in an amount to be limited to a percentage of the assets of the Federal Reserve Bank, to be ascertained and fixed by the Federal Reserve Board.

In discharge of the duty laid upon it by the terms of the Act, the Federal Reserve Board has defined commercial paper eligible for rediscount as paper which arises from some step in the production, manufacture, or distribution of goods.¹ For our purposes, this definition, in conjunction with the negative prescriptions of the law as stated in the preceding paragraph, is significant in that it admits to rediscount all bills of exchange which represent the importation or exportation of commodities; at the same time, discriminating against those loans made by the banks to finance the activities of the stock market or for the purpose of permanent investment by the borrower. This encourages the employment of current cash balances by the banks in the purchase of acceptances in preference to their employment in call loans secured by collateral of stock and bonds, and thus tends to broaden the demand for bills of exchange in the open market. With this superiority, the acceptance has become in New York what it has long been in London — an attractive instrument for equalizing the cash position of the banks.

The law limits the amount of paper bearing the signature or endorsement of any one borrower which the Reserve banks may discount for any one bank to ten per cent of the borrow-

¹ Regulation of the Federal Reserve Board issued January 25, 1915.

ing bank's capital and surplus; this limitation, however, is waived in the case of bills of exchange drawn in good faith against actually existing values — for example, the commercial long bill as it is commonly drawn in international commerce. The banks of the country which are members of the Federal Reserve System¹ may, therefore, freely invest their funds in acceptances of a maturity not longer than ninety days, with confidence in their ability to dispose of their holdings of such bills in case of need. Furthermore, the facilities of the member banks to find relief from an over-extended position have been improved by an amendment to the Act in 1917 which permits any Federal Reserve Bank to make advances to the member banks against their promissory notes for periods not exceeding fifteen days, provided such promissory notes are secured by notes, drafts, or bills of exchange which are eligible for rediscount, or by the obligations of the Government.

Further encouragement is given to the foreign exchange operations of our banks by a clause in the Federal Reserve Act permitting the establishment of foreign branches by national banks having a minimum capital of \$1,000,000, with the consent of the Federal Reserve Board. Banks of this size are also permitted to invest an amount not exceeding ten per cent of their capital and surplus in any financial corporation engaged in international banking. The McClean and Edge Acts,² passed at a later date, increased the power of the banks to coöperate in conducting foreign exchange and foreign financing transactions, and extended the privilege to a wider group of banks than that delimited by the Federal Reserve Act. Availing themselves of this new power, a few of the larger national banks have established branches abroad, especially in Europe and South America. State banks have taken part in the same movement; and certain large financial

¹ All national banks of the country are *de facto* members of the Federal Reserve System, and the law permits state banks to become members by submitting to an examination by the Federal Reserve Board and conforming to rulings of the Board. Only a small proportion of the state banks have availed themselves of this opportunity to become members of the system.

² For a discussion of these laws see pages 311-12.

corporations, owned principally by member banks of the Federal Reserve System, have opened branches in the West Indies, Central and South America, the Far East, India and the Levant, and in Europe. These branches and agencies are subject to the laws of the countries in which they are located; by following the banking practices of these countries, they help to familiarize American business men who deal with their home offices with the financing methods of foreign markets and with their own rights and duties in connection with exchange operations with these markets.

The Federal Reserve Board is also empowered to permit the Reserve banks (as distinct from the member banks of the system) "to open and maintain accounts in foreign countries, appoint foreign correspondents, and establish agencies in such countries wheresoever it may deem best for the purpose of purchasing, selling, and collecting bills of exchange, and to buy and sell, with or without its endorsement through such correspondents or agencies, bills of exchange arising out of actual commercial transactions which have not more than ninety days to run, exclusive of days of grace, and which bear the signature of two or more responsible parties, and with the consent of the Federal Reserve Board to open and maintain banking accounts for such correspondents or agencies." The Federal Reserve Bank of New York has acted extensively under this power. Correspondent relations have been formed with the Bank of England, the Bank of France, and the Bank of Italy; with the Bank of Japan, the Philippine National Bank, and the Banks of Sweden, Norway, and the Netherlands. Agreements have also been made with the Argentine Government and the Government of Peru, covering operations of limited scope; and the British Government has made arrangements to supply the Federal Reserve Bank of New York each month with sufficient rupee exchange to satisfy the requirements of American importers from India. This development of branch banking by the national and state banks, and of close correspondent relations with foreign banks and governments by the Federal Reserve Bank of New York, has brought the New York market into closer union

with the principal financial and trading centers of the world than before. Though the development of foreign branch banking has not yet attained dimensions comparable to the world-wide contacts of the English and German banks before the Great War, the restoration of normal conditions will probably accelerate its pace.

85. The present mechanism of the open market in New York. Since bankers' and trade acceptances do not represent advances of funds by the accepting parties, these instruments cannot function as financing agencies in the absence of a money market in which they can be sold to investors. Such a market cannot be called into existence by law, but must wait upon the development of banking and investment practices which turn the liquid funds of a money center toward the purchase of acceptances in preference to other short-term investments. In the United States, the open market for bills of exchange developed subsequent to, and largely as a consequence of, the changes in American banking practice recorded in the preceding section. It has made extremely rapid progress as greater familiarity with the acceptance has acquainted money-lenders with its superiorities as a safe and convertible short-term investment instrument. The acceptance of bills of exchange by American bankers began in 1915, in which year the Federal Reserve Bank of New York reported the purchase of only \$93,000 worth of acceptances of all varieties. On April 31, 1921, according to the Bulletin of the Federal Reserve Bank of New York, there were outstanding about \$1,000,000,000 in bankers' acceptances; the major proportion of these (the exact figures are not known) arose from the foreign commerce of the country.

In approaching our study of the discount market in which these acceptances are bought and sold, certain cautions must be kept before the mind. In the first place, although the American market for acceptances centers in New York as that of England centers in London, Boston, Chicago, San Francisco, and other financial cities of the country are developing markets which follow the same lines as that of New York, but on a smaller scale. In limiting our inquiry to the

New York market, therefore, it must not be understood that that city constitutes the sole discount market of the country, but, rather, that it is the chief market and the prototype of the others. In the second place, it must be remembered that the New York market has not yet attained a settled and stable structure which make precise and comprehensive description possible. Its experience has been solely with abnormal times, when conditions were unsettled either by the Great War and the world-wide depression which followed it, or by its own immaturity and rapid development. Consequently, the description which follows must be understood to apply only to current and rapidly changing conditions.

We can best proceed by separating the machinery of the market into two major divisions: (a) the creators of the acceptances in which the market deals; (b) the investment machinery of the open market through which funds are advanced to purchase these acceptances. Concerning the former of these divisions, little description is necessary. The trade acceptance has, of course, never been illegal in the United States, though its use prior to 1914 was very rare. In domestic trade, business custom had developed the almost exclusive use of "commercial paper" — the single name "promissory note" — as the typical short-term financing instrument; in foreign trade, for reasons which have been given, the trade bill drawn in dollars was equally rare. The dollar trade acceptance is now being used, not so much as the result of legal changes as of an educational campaign among American business men; though the eligibility of these acceptances to rediscount (when endorsed by a member bank) has certainly increased the demand for them. In domestic trade, the increase in the use of trade acceptances has been especially marked; in foreign trade, they do not rank with the bankers' acceptance, though their use is not unknown.

The making of dollar bankers' acceptances is more directly the result of the legal changes which we have been describing. There are now a number of finance houses, formed principally from capital supplied by bankers and other financiers, organized for the express purpose of making these acceptances.

These institutions do not conduct a general banking business nor carry on open market operations, but exist solely for the purpose of lending their names as acceptors of long dollar bills drawn by merchants and bankers, after the practice of the old acceptance houses of London. The number of these finance houses is increasing. But for the most part, the accepting of bills of exchange is done by the banks — national banks, members of the Federal Reserve System, state banks and trust companies — under the powers recently conferred upon them. The relationship of these banks to their foreign correspondents does not greatly differ from similar relationships of the London banks, described in detail in the preceding chapter. The American banks undertake to handle the long dollar bills bought or taken for collection by their correspondents, obtaining acceptances on these bills and discounting them on the open market, or holding them until maturity according to instructions from abroad. In the second place, they accept long-term dollar bills drawn upon them either by the foreign correspondent or by some one else under authority of a dollar letter of credit issued by the correspondent. Thirdly, they undertake to cash across the counter, out of balances maintained with them by the foreign bank, dollar demand drafts and cables sold abroad. These transactions require the correspondent to maintain with the New York bank an acceptance account and a cash balance, and it is in connection with their duties with regard to the acceptance account that the New York banks become the creators of dollar acceptances of foreign origin. The management of these accounts, the duties involved in their maintenance, and the charges made by the New York banks for services rendered with regard to them, are substantially the same as those discussed in our description of the London market and need not be considered in detail in this place.¹

The machinery of the open market through which funds are advanced in the purchase of acceptances comprises the following groups: (1) the primary buyers of acceptances — investors who buy acceptances on their own account for the gain of

¹ See page 314. -

interest; (2) the middlemen or brokers who, without considerable investment of their own funds, bring buyer and seller together; (3) the secondary buyer—the Federal Reserve Bank to whom investors resell their holdings. This classification is made in full knowledge of the fact that these different groups are not at present mutually exclusive in function. The second and third groups discharge in part the functions of the first; brokers are to some extent investors on their own account, and the Federal Reserve Bank, in theory a strictly rediscounting agency, has always been a large buyer of bills in the open market. However, the separation of function implied in the division is growing more sharply defined as the market develops, and the structure of the market will probably approximate more and more closely this grouping of interdependent organs as time passes.

86. Primary investors in the open market of New York. It is upon the number of primary investors, and the volume of loan funds which they bring forward for investment, that the efficiency of the market is chiefly dependent. Given a large and constantly renewed stream of loan funds converging on the market, and active competition between great numbers of buyers, low and stable rates of discount can be maintained; and bankers in foreign cities can negotiate dollar bills with confidence in their ability to recover their funds at a predetermined cost through access to the open discount market in New York. At present, the primary buyers of bills comprise a mixed group of money-lenders. First of all are the great commercial banks of the city; in the second place, the discount and finance houses which have been organized by financiers for the purpose of investing funds through the discount market; thirdly, a miscellaneous group of money-lenders—savings banks, insurance companies, corporations, private individuals—who enter the market from time to time to give employment to occasional cash balances whose investment must be liquid; finally, the Federal Reserve Bank, for reasons which shall be explained, buys bills in the open market. Through these various channels current loan funds flow to the New York market from different sections of the country.

The commercial banks are constantly adding to their lists of out-of-town customers for whose accounts they are instructed to buy acceptances from day to day. The Federal Reserve Bank of New York has also bought largely for the account of Reserve Banks in other cities; in 1919, for example, out of a total purchase of acceptances to the value of \$1,950,898,000, the Reserve Bank of New York distributed \$739,499,000 as follows:

Cleveland.....	\$179,592,000
Chicago.....	160,173,000
St. Louis	500,000
Minneapolis.....	88,696,000
Kansas City	22,461,000
San Francisco	288,077,000

This broadening of the market at once increases the supply and diversifies the sources of the loan funds which are employed in New York, thus producing the double effect of multiplying the capacity of the market, and defending it from sudden changes in demand which might cause violent fluctuations of the rates of discount.

The commercial banks of New York have begun only recently to invest funds in the discount market. As stated in another place, it had long been their practice to invest that part of their funds which must be kept liquid in the call money market where loans are extended for periods of twenty-four hours against deposits of stocks and bonds. This practice was made possible by the policy of daily settlement of the Stock Exchange which enabled brokers and speculators to finance their operations by means of these short-time loans. But the fact that the practice was so general among the banks is to be attributed to the lack — before the legalizing of the banker's acceptance — of any other form of investment which would be at once liquid and secure. In London, fortnightly settlement by the Stock Exchange reduces the demand for call loans for speculative purposes, while long acquaintance with the banker's acceptance has developed a firmly rooted preference among bankers for the discount market as an out-

let for their current funds. Although New York bankers, to an increasing extent, are breaking away from the methods of the past and adopting the London practice, the call money market still competes with the discount market; when the call rates rise, funds are diverted from the bill market, and turned back into the bill market when they fall. In consequence of this interdependence of the supplies of funds in the two markets, the call money rate and the rate of discount are mutually related, tending to rise and to fall in sympathy with each other. The bill market cannot become in New York what it is in London — the heart of the credit structure — as long as it shares with the Stock Exchange command over the liquid funds of the banks.

The banks hold a two-sided relationship with the open market: they both sell and buy bills of exchange. In discharging the duties involved in their correspondent agreements, or in their relations with their foreign branches, American banks receive by every mail remittances of long dollar bills to be presented for acceptance and discounted in the open market. The New York branches of foreign banks are also engaged in these activities. When, acting in this capacity, the banks of New York appear upon the supply side of the market, they occasionally place the bills which they have for sale directly in the hands of some other primary investor — either their own client, or another bank or finance house; more frequently, however, they make the sale through the bill brokers.

As buyers of bills, the banks draw acceptances from two sources: the remittances received through the mails from foreign correspondents and branches; and the offerings of the bill brokers. The duty of the New York banker to his foreign correspondent requires him to sell the acceptance at the best rate obtainable in the market, but does not debar him from paying this rate himself and obtaining the bill for his own account. An incidental advantage to the banker from his foreign connections is this opportunity to select, from a large and continuous stream of bills, those whose amount, security, and term of life suit them to the needs of the bank-

er's portfolio. That this opportunity is of real value to the banker is evident from the fact that he is accustomed to paying a commission charge for this very service of supplying a classified selection of instruments when dealing with the brokers. The majority of the banks, however, do not enter into correspondent relations with foreign markets; this larger group of banks buy bills directly from the brokers who act as middlemen in the market, or, occasionally, from their own clients.

The other primary investors in the bill market, with the exception of the Federal Reserve Bank whose open market operations will be discussed on a later page, may be thrown into a common group. There have always existed in New York a large number of private investment houses accustomed to buying commercial paper and similar short-term investment instruments; many of these have now opened departments for dealing in acceptances. New discount houses have also been formed with large capital for the specific purpose of operating in the bill market, buying acceptances and holding them until maturity, or selling them again with or without their endorsement. These institutions mark the beginnings of a line of development which in London has led to the establishment of powerful discount houses which supply a considerable proportion of the liquid capital of that great money center. But up to the present, the American discount houses have differed from their English counterparts in that it has been their policy to turn over their assets rapidly, reselling their acceptances whenever market conditions were favorable; whereas the discount houses of London almost invariably carry their holdings of acceptances through to maturity. In addition to these institutions, other primary investors have been attracted by the opportunities of the discount market. Some of the states have amended their laws to permit savings banks and trust companies to invest in bankers' acceptances; corporations and estates with excess funds for short periods, and individual money-lenders, are learning the merits of the acceptance as an investment opportunity. The funds drawn into the market from these differ-

ent and widely scattered sources are continually adding to the financial strength of New York and increasing the ability of the city to withstand the strain put upon it by the use of dollar credits in international commerce.

87. The New York bill brokers. The principal function of the brokers is to provide a connecting link between the sellers of acceptances and the primary buyers. In performing this function, they do not act as investors or suppliers of capital to any great extent, but merely as middlemen. Their day's work consists in making the rounds of the banks, discount houses, and other sources of supply and demand for bills of exchange, ascertaining in each instance what bills are offered for sale and what bills are in demand, and then supplying the needs of the buyers by taking up and distributing the bills offered by the sellers. The brokers are also sought out by business firms and individuals who have acceptances for sale in connection with some mercantile transaction, and are engaged to find buyers for these acceptances. In the last-named type of operation, the bill broker invests no capital at all in the instruments in which he deals, but simply brings buyer and seller together by undertaking to place the seller's bill in the hands of an investor and return to the seller the proceeds of the discount minus a small commission. As middlemen, the importance of the brokers lies in the service they render by sorting the miscellaneous bills of the sellers, and offering them properly classified to meet the peculiar needs of each investor. This service increases the ease with which bills are bought and sold, broadens the market, and stabilizes the rates; the commission earned by the broker is a modest charge for a service of such importance.

But these activities of the middleman do not represent the whole function of the bill brokers. Many, if not all, of the brokers in the open market bring forward capital of their own and thus create a part of the demand for acceptances. In dealing with the larger commercial banks, those which have formed foreign connections and have developed the business of supplying acceptances to the market, the brokers customarily acquire ownership of the acceptances by outright

purchase. This necessitates a command over a certain amount of working capital. A part of this working capital is supplied by the brokers out of their own resources; another part is borrowed at call from the banks on the security of the acceptances which the brokers carry in their portfolios. Some of the larger banks of New York make the statement that they have ceased entirely to lend at call to operators on the Stock Exchange, and have made it their policy to cater solely to the business of the bill brokers. But, on the whole, this practice of extending call loans on the security of acceptances is still in a rudimentary stage of development in the New York market, and the brokers of that market have not as yet found access to that abundance of liquid credit which is at the command of the brokers of London.

It is the policy of the brokers in New York to resell quickly the bills they have bought. The turnover of their capital is rapid; and the acceptances found in their portfolios are but momentarily lodged there on the way into the hands of a more permanent investor. However, a net addition to the demand of the open market may be attributed to the brokers, equal to the number of bills which they own at any given time, irrespective of their intentions regarding the final disposition of these bills. But it must be remembered that the brokers buy these bills only because they are confident of their ability to sell them again to others; in other words, their demand for acceptances is contingent upon the demand of some other group of money lenders, and would not exist but for the demand of this other group. Underlying the market, therefore, and forming the foundation upon which the activities of the brokers are conducted, are the banks, discount houses, and other true investors, willing to advance money upon the security of accepted bills of exchange for the gain of interest. These ultimate investors form one of the two essentials of the discount market; the suppliers of bills form the other essential; the brokers' activities are incidental to the functioning of these more fundamental parts of the machinery of the market.

From this brief description of the activities of the bill bro-

kers, it will be seen that the banks hold toward them a two-sided relationship; they supply the brokers with most of the bills in which they deal, and also afford them the best market in which to sell these bills. There is a slight discrepancy between the rates at which the banks sell to, and buy from, the brokers, the selling rate being sufficiently higher than the buying to afford the brokers a small margin of profit. In the spring of 1921, for example, the spread between the rate of discount used by the banks when selling acceptances and the rate used when buying varied between $1/8$ and $1/16$ per cent; that is, when buying from the banks, the brokers discounted an acceptance at the rate, say, of $5\ 3/4$ per cent, and, when selling to the banks, discounted the same acceptance at the rate of $5\ 11/16$ per cent. It need scarcely be explained that the higher the rate of discount applied to a bill, the lower its sale price, and the lower the rate of discount, the higher its price; hence, by buying at the higher rate of discount and selling at the lower, the brokers paid for their acceptances somewhat less than they received for them. But the margin of profit allowed by a difference of $1/16$ per cent between buying and selling rates is very small, indeed; the life of a typical acceptance is ninety days, and a commission of $1/16$ per cent *per year* on an assortment of bills whose average life is ninety days is equivalent to a commission of $1/64$ per cent on the face value of the amount handled. This charge by the brokers would be considered no more than a reasonable profit in the discount markets of Europe which have had many more years in which to develop.

The services which the brokers render in return for their profit have been explained in part. In London, where the relationship between banks and brokers in the money market is much the same as in New York, the bills which the banks buy have gained in desirability in passing through the brokers' hands; the London brokers always endorse, either by attaching their signatures to the bills or (more frequently) by giving the banks a blanket guaranty covering all items bought from the broker. But in New York, the brokers do not endorse and, consequently, the bill gains nothing in *security*

when passing through their hands. From the standpoint of those banks which supply bills as well as demand them, the brokers provide a valuable opportunity to exchange those bills which do not suit the bankers' needs for those which do, by selling the former and buying the latter. For the banks, discount houses, and other investors who do not supply acceptances to the market, the activities of the brokers save time and expense by bringing to their counters a classified assortment of bills from which to fill the gaps in their portfolios.

Moreover, aside from these specific services, the presence of these middlemen in large numbers conducting their transactions in active competition with each other provides the machinery through which a uniform and stable discount rate can be worked out in the open market. By keeping in touch with the available sources of supply and demand, receiving a multitude of bids and offers from many different quarters, the brokers, by striving against each other to increase their profit and expand their business, adjust the rates of discount to the point which will clear the market. In the absence of these connecting links between buyers and sellers, many discount rates would exist simultaneously applying to the same type of instrument, and the rates would be much more susceptible to fluctuations reflecting the bargaining skill of buyer and seller. Under such conditions, the foreign buyer of long dollar bills could make no reliable forecast of the amount these bills would add to his New York balance when sold in the discount market; and this uncertainty would subject the dollar rates of exchange in foreign cities to wide fluctuations and retard the use of dollar exchange in international commerce.

88. The Federal Reserve Bank in relation to the discount market. In strict theory, the Federal Reserve Bank should act solely as a secondary purchaser of acceptances — an agency of rediscount to which other banks might resort in times of stringency. This was the function of the Reserve Banks contemplated by the founders of the system. However, the Federal Reserve Act made provision for open mar-

ket operations by the Reserve Banks in the following words: "Any Federal Reserve Bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances, and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank." It was intended that these open market operations should be incidental to the chief function of the banks, engaged in to enable the banks to exercise a greater control over the market when it was deemed advisable and to employ their funds when there was no demand for rediscounts. But since the founding of the Reserve System, the direct dealings of the Reserve Banks in acceptances have constituted the largest single influence in the discount market. This situation has arisen naturally because of the former absence of a discount market and the ignorance of money-lenders regarding the excellencies of the acceptance as an investment instrument.

The Reserve Banks conceived it to be their first duty to develop a discount market able to stand upon its own feet. It was necessary to encourage the drawing of dollar bills both in domestic and foreign commerce, and to develop a demand for dollar acceptances by convincing the money-lenders of the city of the merits of this new kind of investment instrument. In pursuance of this purpose, the Federal Reserve Banks have carried on an active educational campaign throughout the country in collaboration with commissions and associations formed by the principal credit and financial institutions; and to give a material impetus to the movement, they have held themselves ready to take off the market all acceptances for which no other purchasers could be found. At the outset, they did not require the endorsement of bankers upon these acceptances, but bought them directly from the first sellers. In this way, the Reserve Banks assured the holders of acceptances of an ever-present market, thus encouraging the use of dollar credits and the exercise by American bankers of their

new powers to make acceptances. It has been the consistent effort of the Reserve Banks, however, to withdraw from the position of primary purchasers of bills by fostering the growth of the market to the point where its funds would be sufficient to carry the volume of business. When this point is reached, the Reserve Banks will hold their own funds in reserve, as does the Bank of England, for use in emergencies.

The following table, giving the total of bills outstanding at different dates and the percentage of these bills held by the Reserve Banks, is significant from many points of view. It discloses the growth of the practice of making acceptances, the early dependence of the market on the Reserve Banks, and the gradual broadening and strengthening of the market to a degree which has made it practically independent.

BILLS OWNED BY THE FEDERAL RESERVE BANKS AT VARIOUS DATES ¹

<i>Date</i>	<i>Owned by the Reserve Bank of New York</i>	<i>Owned by all Reserve Banks</i>	<i>Estimated amount outstanding</i>	<i>Per cent of all bills owned by Reserve Banks</i>
Dec. 31, 1916	\$ 41,457,000	\$ 127,497,000	\$ 250,000,000	51.0
Dec. 31, 1917	148,125,000	275,366,000	450,000,000	61.2
Dec. 31, 1918	69,323,000	303,373,000	750,000,000	40.5
Dec. 31, 1919	191,312,000	583,212,000	1,000,000,000	58.5
Dec. 31, 1920	109,902,000	255,702,000	1,000,000,000	25.6
Mar. 25, 1921	39,386,000	123,056,000	1,000,000,000	12.3

Note. It must be remembered that these figures apply to all acceptances both domestic and foreign.

Early in its history, the Federal Reserve Board, in establishing the rates of discount which were to govern the open market operations of the Reserve Banks, discriminated against the promissory note in favor of the acceptance, and also against the trade acceptance in favor of the banker's acceptance. The example set by these great credit institutions in the open market had the effect of forcing the other banks into line with their policy and thus to establish, as the stand-

¹ Taken from the Bulletin of The Federal Reserve Bank of New York for April, 1921.

ard of the market, preferential rates for acceptances, and especially preferential rates for the banker's acceptance. This has given rise to a schedule of discount rates in the market of New York similar to that of London, with the rate for prime bankers' acceptances at the base of the schedule and the rates for other bills ranging higher according to differences in security and term of life. When *the* open market rate of discount is mentioned in connection with the bill market, reference is had to the basic rate of the system — the rate applying to the prime acceptances of bankers of a maturity which qualifies them for rediscount with the Federal Reserve Banks. The following quotations will illustrate the spread between the different classes of bills:

OPEN MARKET QUOTATIONS FOR JUNE 10, 1921

<i>For spot delivery</i>	<i>ninety days</i>	<i>sixty days</i>	<i>thirty days</i>
Prime eligible bills.....	6 @ 5 7/8	5 7/8 @ 5 3/4	5 7/8 @ 5 5/8
<i>For delivery within thirty days</i>			
Eligible member banks.....	6 1/8 bid		
Eligible non-member banks.....	6 1/4 bid		
Ineligible bank bills.....	6 7/8 bid		

These rates apply only to bankers' acceptances. *Prime eligible bills for spot delivery* may be translated as the acceptances of first-class bankers, eligible for rediscount at the Federal Reserve Bank, and ready for immediate delivery to the buyer. The rates for these prime bills vary, as may be seen by examining the schedule, as between maturities of ninety, sixty, and thirty days; the higher discounts applying to the longer maturities because of the added risk to the buyer involved in the extended period before redemption. The two rates given under each maturity are the "bid" and "asked" quotations, or the buying and selling rates, respectively; it will be seen, by comparing these two quotations, that the spread between them was, on the day in question, not less than 1/8 per cent. The second part of the schedule refers to the rates for future delivery, based upon the policy of the Federal Reserve Bank of publishing a "forward" or "arrival" rate of discount for the use of buyers of long bills in foreign

markets. Reference will be made to this practice in the following paragraph. Reference to the table of rates for future delivery given above will disclose the fact that the market discriminates between bills eligible for rediscount with the Reserve Bank and those ineligible for rediscount; and also discriminates between eligible bills on the basis of their acceptance by member and non-member banks of the Federal Reserve System. Especially sharp is the discrimination between eligible and ineligible bills; in the table given, the lowest rate for eligible bills for future delivery is $6\frac{1}{8}$ per cent, while the lowest rate for ineligible bills is $6\frac{7}{8}$ per cent, a difference of $\frac{3}{4}$ per cent in favor of the former. This difference between the buying prices for the two classes of bills is an indication of the power of the rediscount privilege to increase the demand of investors.

As stated above, the Federal Reserve Bank has adopted the practice of publishing a "forward" or "arrival" rate of discount for the use of buyers of long dollar bills in foreign markets. At this rate, bills which arrive in the market within the specified time limits will be discounted. Foreign bankers, possessed of this information, are able to ascertain in advance of purchase how much a given dollar bill will increase their New York balances if discounted immediately after acceptance. By drawing their own sight drafts for this amount, the foreign bankers can offset their purchases of long dollar bills without delay, and from the ruling dollar sight rate can calculate the buying price for the long bill. The publication of a forward rate of discount has, therefore, the important effect of stabilizing the dollar rates of exchange in foreign markets, thus reducing the risk of exchange borne by exporters who finance their transactions with long dollar bills, and stimulating the use of dollar exchange. In the absence of a forward rate of discount, the dollar rates in foreign markets would, of necessity, contain a large element of insurance to protect the banker against possible adverse fluctuations in the New York discount rates while the bills were in transit. The commercial banks of New York which have formed correspondent agreements with foreign bankers, or have estab-

lished their own branches abroad, send periodic advices to their associates in the foreign centers upon this subject of the market rates of discount in the near future.

So far we have been speaking of the open market operations of the Federal Reserve Bank, and of the effect of these operations upon the market. But the original purpose of the Federal Reserve System was to establish a group of institutions whose primary function should be that of *rediscount*. That the open market operations of the Reserve Banks have bulked so large in the total business of the market has been due to the market's lack of an adequate supply of loan funds drawn from other sources, a condition which, it is hoped, will disappear in time. The provisions of the Federal Reserve Act with respect to the eligibility of bills for discount may be summarized as follows: (a) the bills must be the acceptances of member banks of the System, or of non-member banks which have fulfilled certain requirements of the Federal Reserve Board; (b) they must be "commercial" bills,¹ or bills secured by Government bonds or notes; (c) they must have a maturity not longer than ninety days; acceptances with a tenor of more than ninety days, if eligible in other respects, become rediscountable ninety days before their maturity. Evidence of eligibility must appear on the face of all rediscounted bills in the form of a rubber stamp endorsement.²

The distinctive and most important function of a rediscounting agency is to afford the credit institutions of the country a method of relief from an over-extended position during periods of credit stringency, but to do this in a manner that will check the expansion of credit and relieve the stress. This double purpose can be achieved only on one condition: namely, that the rediscount rate is *higher* than the rate of discount in the market at the time when rediscounting begins. The banks which resort to rediscounting must do so at a loss of profit to themselves, else there would be no incentive for

¹ See definition on page 377.

² The Reserve Banks rediscount promissory notes, in addition to bills of exchange, and also make fifteen-day collateral loans to their members based on bills, notes, and Government bonds.

them to raise their rates to their customers, and no pressure upon the market to curtail the expansion of credit. When the rediscount rate is lower than the market rate, the banks may recover the funds they extend in the purchase of acceptances and to other borrowers at a cost lower than the charge they make their own customers for the use of these funds. This situation merely encourages the banks to pass their paper over to the rediscounting agency and continue lending; the assets of the Reserve Banks under such conditions simply form an additional reservoir of credit to be absorbed in the market, and credit expansion is allowed to run to greater extremes than if the banks were compelled to rely upon their own resources. Obviously, this defeats the purpose of the rediscounting agency. The cardinal principle that the rediscount rate must be higher than the market rate has been carefully observed by the central banks of Europe. The Bank of England, for example, has never allowed its rate to remain lower than the market rate of discount during the last half-century; and a similar policy has been followed by the Bank of France, the Bank of Germany, and the other central banks of Europe. In these countries (we deal, of course, with conditions prevailing before the Great War) resort to rediscounting is had only at a sacrifice to the borrower; during quiet periods, when the banks can carry the business of the market without rediscounting, the rediscount rate stands, nevertheless, above the market rate and the central banks are content to allow their funds to remain comparatively idle until occasion arises for their use.

The abnormal conditions which have prevailed, practically from the beginnings of the Federal Reserve System, have prevented the Reserve Banks from conforming to this cardinal principle of the rediscounting agency. Before the discount market was well established, the United States was at war; and during the war period, the rediscounting policy of the Reserve Banks was determined by political exigency and not by considerations of business prudence. The most serious business of the Reserve Banks was that of aiding the Government in the sale of war bonds. The banks and credit

institutions of the country were encouraged to extend credit to their depositors, at rates of interest no higher than the bond rate, for the purpose of buying these bonds; and the Federal Reserve Board, to encourage this policy, was compelled to fix the rediscount rate with reference to the bond rate to the end that the banks, which were forced to rediscount heavily in order to carry the burden of war financing, might do so without loss to themselves. The result of this policy was to allow credit expansion to proceed unchecked to a point far beyond normally safe limits. During the severe crisis of 1920, the rediscount rates were advanced, but the bankers' rates of discount for most classes of commercial paper were also advanced to a position above the rediscount rates. The record of the Federal Reserve Banks, therefore, cannot be taken as indicative of the relationship which they will hold toward the market, and the power they will exert over the operations of the market, when they have begun truly to function as agencies of rediscount.

The interrelation of the Reserve Bank and the open market for acceptances in New York cannot be compared with that of the Bank of England to the discount market of London. The Bank of England does not rediscount commercial loans and advances made by the London banks; it rediscounts only bills of exchange. It has been estimated that of the assets of the London banks under normal conditions, about twenty-five per cent consists of bills.¹ The rediscounting policy of the Bank of England is brought to bear upon this portion of the banks' assets, only; hence, the discount market for acceptances is immediately influenced by this rediscounting policy in times of stringency. All interest rates respond quickly to changes in the rates for bankers' acceptances, since it is through the agency of rediscounted acceptances, if at all, that the banks will find relief from a condition of strained credit.² The discount market, therefore, forms the

¹ See *The Chase Economic Bulletin* for July 20, 1921, p. 9.

² The London banks do not rediscount directly, but avail themselves of the opportunity to reduce their holding of bills through the medium of the exchange brokers. See the discussion on pages 336 f.

channel through which the Bank of England brings its influence to bear upon the credit structure of London. The Official Rate of the Bank is set with reference to the basic discount rate of the open market for bills of exchange.

**DISCOUNT RATES OF THE FEDERAL RESERVE BANKS IN EFFECT
JUNE 10, 1921**

<i>Federal Reserve Bank of</i>	<i>Discounted bills maturing within ninety days (including member banks fifteen-day collateral notes) secured by</i>			<i>Bankers' acceptances discounted for member banks</i>	<i>Trade acceptances maturing within ninety days</i>	<i>Agricultural and live- stock paper maturing 90 to 180 days</i>
	<i>Treasury certificates of indebtedness</i>	<i>Liberty Bonds and Victory Notes</i>	<i>Otherwise secured and unsecured</i>			
Boston.....	6	6	6	—	6	6
New York.....	6	6	6½	6	6½	6½
Philadelphia.....	*6	5½	6	6	6	6
Cleveland.....	6	6	6	6	6	6
Richmond.....	6	6	6	6	6	6
Atlanta.....	6	6	6	6	6	6
Chicago.....	6	6	6½	6	6½	6½
St. Louis.....	6	6	6	5½	6	6
Minneapolis.....	6	6	6½	6	6½	6½
Kansas City.....	*6	6	6	5½	6	6
Dallas.....	6	6	6½	6½	6½	6½
San Francisco...	6	6	6	6	6	6½

* Discount rate corresponds with interest rate borne by certificates pledged as collateral.

In New York, on the other hand, acceptances not only form a much smaller percentage of the assets of the banks, but they also form but one of a number of contacts between the central agency of rediscount and the banks of the city. It will be seen, by examining the table of rediscount rates given on this page, that the Reserve Banks rediscount not only bills of exchange, but other types of commercial paper as well. At present, trade and bankers' acceptances supply a minor share of the rediscounts. To base the rediscount rates of the Reserve Banks upon the open market rate for acceptances would not, under these conditions, directly and immediately affect

the credit policy of the commercial banks, as a similar practice of the Bank of England affects the credit policy of the banks of London. Reference to this table will show that the rediscount rate for bankers' acceptances in New York stood, on June 10, 1921, at 6 per cent; on the same day, the open market rate for this type of acceptance varied from 6 to $5\frac{5}{8}$ per cent according to maturity. The rediscount rate, therefore, was, on the whole, higher than the market rate for bankers' acceptances; but the banks were not compelled to rediscount *acceptances* in order to obtain advances from the Federal Reserve Banks, since they could borrow on their fifteen-day paper. The rate on this date for advances to the banks on their fifteen-day paper secured by other than Government obligations was $6\frac{1}{2}$ per cent. But the rate prevailing in the market for commercial loans was a full half per cent higher at this time; hence, the banks could extend loans to their customers under the ordinary "line of credit" policy, and make an additional profit by borrowing from the Reserve Banks the money thus loaned. To make their rediscount rate effective at a time when the Reserve Banks desire to check the credit expansion of the country would require a raising of each of the rediscount rates to a point higher than the interest rate applying to the particular kind of paper upon which the rediscount was based. In this respect, the New York market contrasts strikingly with the London market where single rediscount rate, applying only to bankers' acceptances, is effective to control the entire schedule of interest rates in the money market. What the future will bring forth with regard to the relationship of the Reserve Banks to the discount market depends, in large part, upon the development of the dollar acceptances and the increased importance of acceptances among the assets of the banks.

International relationships have been so abnormal since the founding of the Federal Reserve System that it is impossible from the record to predict with confidence whether the Reserve Bank of New York will ever hold a position of international importance similar to that of the Bank of England. Certain possible lines of development may, however, be

marked out. If the discount market continues to develop, and if the Reserve Banks consistently follow the policy of holding their rediscount rates above the market rates, it should be possible to equalize the rates of interest between the New York market and the markets of other countries; and possible, also, to exert some degree of control over the flow of gold to and from New York. In the past, New York has been more or less isolated; it has never been able to exert the far-reaching influence over the credit conditions of the world as has the market of London. But the broadening of the New York market and the development of stable rates of discount there should bring this isolation to a close. A stable discount market will encourage foreign bankers to buy dollar acceptances when the discount rates in New York are relatively high; and to sell these acceptances in New York when the interest rates there are relatively low. By buying dollar acceptances when the New York rates are higher than the rates in foreign markets, foreign bankers will diminish the number of bills offered on the discount market of New York, and, at the same time, absorb a part of the loan funds in their own markets. The result of this practice will be to bring the New York rates of interest down and the foreign rates up, until they tend to equal each other. The selling of dollar acceptances in New York when the rates of interest are lower than the foreign rates will tend to reach the same end by a reverse process. This practice will increase the supply of acceptances in New York and release a part of the loan funds abroad; in other words, it will increase the demand for funds where the rate of interest is low and the supply of funds where the rate is high, which, obviously, will tend to equalize the rates. These developments lie in the future and are conditioned upon the growth of the discount market.

Closely related to this reaction of the New York rates of discount upon those of other markets is the possibility, granted an adequate development of the bill market in New York, of controlling the flow of gold to and from the United States by methods similar to those used by the Bank of England. The lack of a central rediscounting agency, and the absence of an

open bill market, have made it impossible in the past for New York to exercise an intelligent control over these gold movements; but in the present mechanism of the market exists machinery which may make this possible in the future. To repeat the gist of an earlier explanation, gold flows out of a country when that country's bills are quoted in foreign markets at the specie importing point; and this will come to pass when there is an excess supply of these bills offered for sale abroad. Under these circumstances, for a central bank to influence the foreign dollar rates so that the flow of gold from New York will be checked requires two essentials: there must be an active open market for bills of exchange in New York, and the rates in this market must be under the control of the rediscounting agency. In times past New York has had neither of these essentials; in the future, provided the open market develops sufficient strength, the Federal Reserve Bank may enjoy power to control gold movements.

When a central institution advances the rediscount rate and forces the market rates to rise, the rates of exchange in foreign markets are affected through four channels: (a) the higher discount rates will encourage the holding for investment of long bills drawn on that market, thus reducing the amount of sight drafts offered abroad; (b) it will discourage the drawing of finance bills on that market, thus preventing the issue of sight drafts against them as cover; (c) it will encourage the closing out of existing loans contracted by foreign bankers in that market, which will increase the demand for sight drafts abroad; (d) it will encourage bankers in that market to draw finance bills on foreign bankers which will increase the demand for sight drafts abroad.¹ Two of these forces diminish the supply of sight drafts drawn by foreign bankers on the market where the rates of discount are rising; two of them increase the demand for these sight drafts; the combined effect being to raise the sight rate, whose decline to the specie point was the cause of the loss of gold by the market in question. However, before the Federal Reserve Banks can exert so significant an influence over the conditions in foreign

¹ For fuller exposition of these forces see pages 343 f.

markets, the discount market of New York must have developed to such a point that foreign bankers habitually carry investments in long dollar bills, and these dollar bills arise in all parts of the world as financing agencies in the trade, not only of the United States, but of other countries as well. In other words, the long dollar bill must have become what the sterling bill has long been — a standard financing instrument of international commerce; and the discount market of New York must have become the rival of that of London as a center of the credit operations of the world. Sufficient time has not elapsed since the improvement of the credit machinery of New York to permit the dollar bill and the discount market to attain this preëminence.

89. Dollar exchange. At the beginning of this chapter, certain handicaps were described which, until recent years, prevented dollar exchange from becoming a financing agency of large importance in international commerce. We have now examined the changes which have occurred since the passage of the Federal Reserve Act; so far as they inhered in a lack of adequate machinery in the New York market, the handicaps to the growth of dollar exchange have been removed. In concluding this subject, we may with profit revert to the question of dollar exchange with the purpose of studying its development since these changes, and of forecasting its probable future.

The use of dollar exchange made possible by the legalization of bankers' acceptances and the establishment of a discount market in New York, and encouraged by the spread of American branch banks abroad, was greatly stimulated by the Great War. In the first place, the United States soon became for neutral nations the only available market in which to buy many of the goods formerly supplied by England, Germany, and France, and for the belligerent countries the sole source of supply for many indispensable commodities. This insistent demand for the products of the United States has continued with little diminution down to the present time; it has made possible the imposition of stringent terms of payment, either cash against documents in New York, or the

establishment of a dollar credit in favor of the exporter. These terms of payment require the use of dollar exchange. In the second place, the Government and people of the United States have made immense loans in dollars to many foreign nations, and especially to England and France. These vast dollar credits have been used to finance the trade of the borrowing nations not only with the United States, but with other countries as well, supplanting for the latter purpose the sterling credit. Finally, a number of the larger American banks have made a concerted effort to popularize the dollar credit both at home and abroad, being aided in this effort in foreign countries by the reliance of the world upon the United States for goods and credit. The results of these different forces have been very marked. In many markets — among them Brazil, Argentina, Greece, India — dollar exchange is now quoted for the first time; in Japan and China, where payment was formerly made in sterling, dollars have become the most easily negotiated of all forms of exchange; direct exchange has begun between the United States and South Africa and other parts of the British Empire. This evidence has been hailed, though somewhat prematurely, by American observers as evidence that New York has already supplanted London as the center of the world's business in foreign exchange.

There are some factors in the present situation which will tend to perpetuate the dominance of New York, or, at least, to assure that city a permanent position in international finance of greater importance than she has enjoyed in the past. The creditor position of the United States, the rise of our country to prominence as a carrier nation, the rapid increase in our foreign commerce, the improvement of our banking structure and the spread of American banks throughout the world, will coöperate to increase the usefulness of dollar bills and to improve the foreign market for these bills. Over against these forces, in any attempt to measure the comparative strength of London and New York, must be set exactly the same forces working with at least equal power in favor of London; and, in addition, the prestige and good-will which London has built up through a century and a half of continu-

ous and successful operation. However, this method of forecasting the future of the two markets is of little significance; in the final analysis, the decision as to the kind of exchange to be used for financing international trade will rest with the merchants who must pay the financing costs. That type of bill will be used which is most easily negotiated and for the highest price by the drawer, and this matter will be decided by the efficiency of the discount market in which the bills are offered for sale by their buyers. Tendencies which increase the foreign market for demand drafts drawn in dollars will lend support to the use of long dollar bills. But if New York is to become the center of the world's foreign exchange markets, and the long dollar bills the typical financing instruments in international commerce, the discount market of New York must first develop to a point where it is able to discharge with ease all calls made upon it to advance funds for the purchase of acceptances, and the rates in that market must be as low as, or lower than, those offered by London and other centers. Until the present time it cannot be said that either of these conditions has been fulfilled.

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